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Issues Paper on Conduct of Business Risk and its Management

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1. Background and purpose

1. The IAIS *Application Paper on Approaches to Conduct of Business Supervision* ("the COB Supervision paper")[1] points out that, historically, insurance supervisors have sought to protect policyholder interests mainly by focusing on the financial soundness of individual insurers and, in more recent times, extending this focus to the financial soundness of insurance groups and conglomerates. Although it has long been recognised that supervisory systems should also protect consumers from unfair or abusive business practices, this has typically been regarded as secondary to maintaining financial soundness.

2. However, the impact of poor business conduct has attracted more attention in recent years. Conduct failings can and do occur in, and affect, individual insurance markets. The recent global financial crisis highlighted that poor conduct of business can also give rise to systemic risks. Not only does poor conduct affect individual customers, it can impact whole markets, the reputation of individual insurers and consumer confidence in the sector as a whole.

3. Financial sector supervisors need to ensure that supervisory frameworks adequately address both prudential and conduct of business risks, and also recognise the differences and interlinkages between the two.

4. Prudential and conduct of business supervision pursue a common goal in protecting the interests of customers. Indeed, the connection between consumer protection and financial soundness is made in the IAIS's mission statement: "The mission of the Association is to (a) promote effective and globally consistent supervision of the insurance industry in order to develop and maintain fair, safe and stable insurance markets for the benefit and protection of policyholders; and to (b) contribute to global financial stability."

5. While ICP 8 (Risk Management and Internal Controls) and ICP 16 (Enterprise Risk Management for Solvency Purposes) address the identification and management of risk within an insurer, IAIS literature in general is currently limited in its discussion of conduct of business risks. It could be argued that conduct of business risks are implicitly considered to fall within the references in those ICPs to "operational risk", which requires appropriate risk management (ICP 8) and sufficient capital (ICP 16). However, there is benefit to having more discussion specific to the management and/or mitigation of conduct of business risks.

6. In the aftermath of the financial crisis, supervisors' immediate priorities were to focus on prudential regulatory issues, including strengthening capital. As the concept of conduct of business risk now gathers momentum globally, it is timely that the IAIS considers this form of risk in more detail within the context of supervision of the insurance sector.

7. In its guidance on *Supervisory Interaction with Financial Institutions on Risk Culture*[2], the Financial Stability Board (FSB) addresses business conduct as a key element of a sound risk culture: An environment that promotes integrity should be created across the institution as whole, including focusing on fair outcomes for customers.

8. In describing conduct of business risks and their mitigation, this Issues Paper seeks to contribute to a comprehensive understanding and assessment of a sound risk culture and raise awareness of conduct of business risk. It documents ideas on the scope of, and approaches to, conduct of business risk management that IAIS members may wish to

[1] IAIS *Application Paper on approaches to conduct of business supervision*, paragrapgh36. (http://iaisweb.org/index.cfm?event=getPage&nodeId=25248)

[2] See FSB: *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture, A Framework for Assessing Risk Culture*, 7 April 2014 (http://www.financialstabilityboard.org/wp-content/uploads/140407.pdf).

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consider when implementing and supervising compliance with ICP 19 on Conduct of Business, ICP 18 on Intermediaries and ICP 9 on Supervisory Review and Reporting. More particularly, the paper considers the sources and impact of conduct of business risk and its place within risk management frameworks. It also considers the mitigation of conduct of business risk in terms of both the management of conduct of business risk by the regulated entities themselves and the role that the supervisor can play. In doing so the paper discusses some of the broader consequences that can come from inadequate management of conduct of business issues, such as harm not only to policyholders but to insurers, intermediaries and the insurance sector as a whole. In this regard, the linkages between conduct of business risk and risks to financial soundness (prudential risk) are considered.

9. Section 1 provides the background for the paper and describes its purpose. Section 2 discusses conduct of business risk and its impact; section 3 outlines the sources of conduct of business risk; section 4, provides a description of conduct of business risk management; section 5 adds considerations on the supervisor's role in monitoring insurers' and intermediaries' conduct of business risk. Finally, concluding remarks are made in section 6.

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2. Conduct of business risk and its impact

10. It is useful firstly to consider what – for the purposes of this paper – we mean by "conduct of business risk". In the COB Supervision paper[3], the point was made that different jurisdictions interpret the scope of conduct of business supervision differently. For example, in some cases conduct of business supervision is seen as part of a broader "market conduct" mandate, which includes supervision of market efficiency and integrity aspects such as disclosures to the financial markets, financial market infrastructures (e.g. securities or other exchanges), insider trading and market abuse, and related activities. It would follow that in such jurisdictions the understanding of conduct of business risk would therefore also encompass these broader elements. The COB Supervision paper however confined its discussion of conduct of business to matters "primarily concerned with the fair treatment of customers", in line with the language used in ICP 19. This Issues Paper adopts a similar approach. For purposes of this paper, a high-level description of conduct of business risk might therefore read as follows:

> "Conduct of business risk can be described as the risk to customers, insurers, the insurance sector or the insurance market that arises from insurers and/or intermediaries conducting their business in a way that does not ensure fair treatment of customers."[4]

11. It includes the risks to which insurers, intermediaries and the insurance sector become exposed as a result of their poor business conduct, as well as the risks to which such conduct exposes their customers.

2.1 Linkages between conduct and prudential risk

12. The interaction between conduct of business and prudential risks may be a dynamic one. For example, poor management of prudential risk may lead to an insurer or intermediary being under financial pressure, which could increase the risk of poor customer treatment such as unfair pricing, inappropriate "hard selling" sales tactics, or unfair claims handling. Conversely, persistent poor customer outcomes may in turn expose an entity to reputational, legal and regulatory risks that could ultimately threaten its sustainability.

13. The definition above suggests that there are key differences between conduct and prudential risks. These differences will lead to different but complementary approaches to risk management and supervision.

Differences in scope and interaction between prudential and conduct of business risks

14. The first difference is a difference in scope. Conduct of business risks includes risks to which insurers and intermediaries become exposed as a result of the way in which they conduct their business. Equally, the way in which insurers and intermediaries conduct their business could expose them to prudential risks. All such risks should be assessed

[3] Paragraph 2.2.1

[4] In accordance with ICP 19, the supervisor sets requirements for the conduct of the business of insurance to ensure that customers are treated fairly both before a contract is entered into and through to the point at which all obligations under a contract have been satisfied. ICP 19 describes the principle of fair treatment of customers as encompassing concepts such as ethical behaviour, acting in good faith and the prohibition of abusive practices.

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holistically. However, while prudential risk management focusses almost entirely on risks to the insurer or intermediary itself, conduct of business risks also cover risks faced by the customers of those insurers or intermediaries.

15. In seeking to ensure financial soundness, insurers may focus on mitigating prudential risks through underwriting and administrative practices that promote profitability and contain costs. If too aggressive, these can compromise the interests of their customers in terms of ensuring that product benefits, terms and conditions, and product servicing deliver fair outcomes for customers.

16. Recognising the interaction between conduct risks and prudential risks over time is of utmost importance for insurers' risk management frameworks.

17. As pointed out in the COB Supervision paper[5], contrary to what happens in the case of prudential risks, conduct of business risks may not constitute immediate or direct threats to an insurer's sustainability and soundness, and consequently may not initially attract the attention of prudential supervisors. Nevertheless conduct of business risks can ultimately lead to prudential concerns.

18. This is why monitoring conduct of business risks may play a significant role in the early detection of issues that could affect the financial strength of an insurer, and provide an important input into prudential supervision.

19. For example, unfair or misleading business practices can be symptoms of insufficient control over distribution channels. They can also be signs of inappropriate governance or ineffective internal controls. Ultimately such issues can trigger financial difficulties where insurers need to reassess existing commitments or redress the mis-selling of products. In the same way, inappropriate claims payment policies can be a means to compensate for otherwise unprofitable products or other financial pressures. By identifying unfair customer outcomes, conduct of business supervisors can help prudential supervisors in anticipating emerging prudential concerns.

Complementary impacts of prudential and conduct of business risks on financial stability

20. The second point of interaction between conduct risks and prudential risks is the different but complementary roles they play in relation to financial stability.

21. Prudential and conduct of business rules pursue a common goal in protecting the interests of customers and ultimately contributing to financial stability. Indeed, the connection between customer protection, financial soundness and stability is made in the IAIS's mission statement: "The mission of the Association is to (a) promote effective and globally consistent supervision of the insurance industry in order to develop and maintain fair, safe and stable insurance markets for the benefit and protection of policyholders; and to (b) contribute to global financial stability.

22. The recent global financial crisis highlighted that systemic risks can arise not only through poor financial and capital management, but also in poor conduct of business practices. As part of its work on risk governance, the Financial Stability Board (FSB) identified poor business conduct as a source of financial instability, leading to the FSB doing further work in this area[6].

23. For example, to manage their prudential risks, financial institutions, including insurers, may be tempted to transfer more risks to the customer or accept less risks from

[5] See paragraph 36.

[6] See footnote 2 and sections 1 and 3.2

them. If conduct of business risks are not appropriately managed, this may lead to the accumulation of risks that customers are not aware of or not able to sustain and this accumulation may in turn have a damaging impact on their trust in the insurance or financial sector.

24. There is, therefore, a direct link between monitoring conduct of business risks and the objective of financial stability. Reducing conduct of business risks and promoting fair conduct of business practices contribute to increase customers' trust that regulated entities operating in insurance markets will treat them fairly. Conduct of business supervision therefore contributes to financial stability. Conversely, promoting stability of the financial sector, including prudential supervisory action, can be considered as a way to enhance the protection of customers.

25. Conduct of business supervision addresses the balance between customers and the industry by requiring insurers and intermediaries to consider the best interest of their customers, leading to customer trust and confidence and hence promoting insurance market stability.

26. The interaction between conduct and prudential risks means that addressing these risks through supervision requires appropriate coordination between conduct and prudential supervisors. This is discussed further in section 5.

Risk indicators

27. The differences and links between prudential and conduct of business risks can also be illustrated by the differences and linkages between the indicators used to identify these risks.

28. Assessing prudential risks typically entails close monitoring of indicators such as profit, growth, cost, claims and combined ratios. On the one hand, the development of an insurer's profit and growth, for example, has effects on its capital and solvency. On the other hand, the same indicators can serve as conduct risk indicators (see Annex I on conduct risk indicators or "red flags"). Looking through the prudential supervision lens, high profit – provided it appears sustainable - is typically considered beneficial for an insurer's capital and solvency. From a market conduct perspective, it is possible that an insurer may be earning high profits because it is efficiently managed and may offer good value to customers. But high profit (historic and planned) may also be driven at the expense of fair customer outcomes, so may be an indicator of products which offer poor value to customers, or aggressive selling practices or high incentives for inappropriate sales. It is therefore crucial to apply both prudential and conduct considerations to an assessment of financial data.

29. However, to complement the prudential approach, monitoring of conduct of business risks needs to recognise the social and legal context of the market and the nature, scale and complexity of insurers' and intermediaries' businesses from a customer perspective. It is also concerned with ensuring that both the collective interests of customers and the interests and needs of individual customers are appropriately taken into account throughout the product life cycle (ie from product design through to the point at which all obligations under a policy have been fulfilled).

30. Conduct of business risks indicators may therefore comprise a relatively greater proportion of quantitative information than prudential risk indicators. Their focus may also be different and comprise both indicators applied at the level of the individual insurer and indicators aimed at assessing market outcomes more globally. For this purpose, conduct risk indicators may be drawn from internal sources (internal to the insurers or intermediaries) as

well as external sources, in order to obtain a picture that is as complete as possible, and to monitor the market in the most holistic way.

2.2 Impacts of a failure to manage conduct of business risk

Customers

31. Failure to adequately manage conduct of business risk has a direct impact on customers. It may lead to customers being sold products they do not need and / or failing to buy the insurance products they do need or being inadequately insured. Also, customers may experience a range of unfair outcomes, including not having their reasonable benefit and service expectations met.

Individual insurers

32. There is link between a conduct of business risk exposure for customers and for insurers or intermediaries. Persistent or materially poor outcomes for customers will lead to adverse impacts for insurers or intermediaries themselves. For example, customer complaints may lead to reputational risks and/or a decline in business. A failure to properly manage conduct of business risk may transform into a legal/regulatory risk, also leading to reputational damage and/or it may affect the financial soundness of the individual insurer or intermediary. Ultimately, the reputation of the industry can suffer.

33. In the Netherlands, for example, one financial institution sold mortgages jointly with term life insurance and made their customers pay these simultaneously, charging very high premiums. This led to overpriced mortgages in relation to the value of the underlying property. Due to rising interest rates, multiple consumers faced detriment. This has generated a lot of negative publicity, let to a bank run and ultimately to a bankruptcy.

Broader adverse impacts

34. Conduct of business risks can emerge more broadly within insurance markets and have market-wide impact in that market, ultimately affecting the financial stability of the market concerned. For example, in the UK, the mis-selling of payment protection plans had a market-wide impact (see Annex II for details on this example). As noted in the COB Supervision paper, the global financial crisis demonstrated that systemic risks can arise not only through failings in financial and capital management but also from poor conduct of business practices. The indiscriminate marketing and poorly targeted sales of sub-prime mortgage products is an example of how failings in conduct can contribute to systemic financial instability.[7]

35. Significant market conduct failures can materially affect the confidence in particular insurance products or the insurance sector as whole. In particular, mis-selling practices where the products are sold on a large scale without proper disclosure to consumers who cannot afford or need them may be source of long term mistrust in the insurance industry.

36. For example, in Slovenia, there was a large scale operation by non-licensed insurance intermediaries in the late '80s and early '90s selling life insurance policies issued by non-licensed insurers. The essence of the operation was a pyramid or Ponzi scheme. The main motives of the policyholders for buying insurance was participation in a pyramid scheme (in view of future commissions) and promised future profits from the policies. Together with high inflation in the late '80s, such sales practices virtually destroyed the life insurance market for several years. Slovenian regulators and the supervisor have resolved

[7] See paragraphs 2-3.

the issue with strict licensing requirements; however, the consequences might occasionally still be felt in certain sales practices and in the perception of life insurance by consumers. Moreover, at least one insurer has been denied entry into the Slovenian market until it has resolved the issue of selling non-approved policies.

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3. Sources of conduct risks

37. As discussed in the COB Supervision paper, the sources and indicators of conduct of business risk may differ from those monitored by supervisors focussing on prudential risk. Sources of conduct of business risk may be broadly grouped into:

- Inherent factors: These are factors inherent in the nature of insurance business and, in many cases, inherent in the nature of financial service provision more broadly. They would include aspects of the very nature of financial products and services, information asymmetries between consumers and industry players, and aspects of the behaviour of financial customers generally

- Factors related to governance and business processes: These are factors where aspects of the insurer or intermediary's own governance models or business processes can contribute to conduct of business risk

- Economic and environmental factors: These are factors related to the external environment in which an insurer or intermediary conducts its business, but which are typically outside its control.

These factors are expanded on in sections 3.1 to 3.3 below.

3.1 Inherent factors

Inherent nature of insurance products and how they are distributed

38. Unlike typical consumer goods, financial products such as insurance products are intangible. Customers cannot see, touch or taste the product they are purchasing and are therefore unable to immediately assess whether the product meets – or does not meet - their needs or expectations, in the way they would do if they were purchasing a physical asset. This adds to the complexity of insurance transactions from a customer perspective. The need for fair, complete and appropriate product information at point of sale is therefore far greater for financial products than for tangible consumer goods.

39. Related to this, the benefits of insurance products are only realised a considerable time (sometimes many years) after the purchase, when a claim arises or when the customer seeks to access savings or investment benefits. Unless sufficient and appropriate information is provided – and understood – at both the point of sale and at appropriate stages during the life of the product, it is often only at this much later stage that mis-selling, inappropriate advice or product limitations become apparent, resulting in a failure to meet customer benefit expectations. The need for adequate ongoing information to ensure that customer benefit expectations are managed and that insurance products remain suitable over the life of the product is therefore far greater than for many other purchases.

40. One particular inherent feature of insurance products – particularly non-investment insurance products - is that their sales are essentially "supply driven." As opposed to physical assets or even other financial products (such as banking or investment products) consumers are not *per se* inclined to buy them. Most of the population is to a higher or lower degree aware that it needs some sort of insurance protection; however, the benefit of insurance is not obvious for the consumer. This feature of insurance is reflected in various phrases commonly applied to insurance: "Everybody needs insurance, but nobody wants to buy insurance"; "Insurance is sold, not bought", "Insurance is a grudge purchase".

Insurance, in essence, reminds consumers of the adverse events that can occur to them and, in order to protect themselves, forces the consumers to spend money on insurance cover.

41. These inherent features of insurance are the source of particular risks connected with the business model of insurance sales. As an intangible, supply driven product, insurers have to adopt distribution strategies that will overcome the lack of inherent consumer demand. The insurance industry has dealt with this inherent challenge in various ways.

42. The most common strategy is to utilise intermediaries to market insurance products on the insurer's behalf, and persuade the customer of the need for and benefits of insurance coverage. In most cases, intermediaries approach prospective customers (including visiting them at their own homes or workplaces) with a view to recommending a product rather than relying on the consumer to initiate contact. The most common model for remunerating insurance intermediaries for their services is for the insurer to pay them commissions based on number and value of successful sales. Commissions are often coupled with additional incentives to achieve particular sales volumes and / or the setting of minimum sales targets

43. Within the context of insurance distribution, intermediaries play a very valuable but potentially sensitive role. On the one hand, insurance intermediaries play a pivotal role in addressing the risks faced by customers and ensuring proper insurance coverage. The intermediary also plays an essential role in mitigating the information asymmetry risks discussed below, by placing the customer in the position to make an informed purchase decision and educating the customer on the nature and benefits of insurance.

44. On the other hand, the traditional commission based remuneration model for insurance intermediaries can be a significant source of conduct of business risk. The commission model – designed primarily to reward and incentivise sales - may create misalignment between the interests of the insurer and intermediary on the one hand and the interest of the customer on the other. In some jurisdictions, commission as a form of remuneration is seen as introducing inherent conflicts of interest, and steps have been taken to prohibit or limit the payment of commissions. (See further discussion on *Conflicts of Interest* in section 3.2). Arguments are however also raised that any such interventions should be considered carefully as they may result in limiting consumers' access to advice and under-insurance.

45. Other mechanisms insurers use to address the "supply driven" nature of insurance include direct marketing strategies where insurer representatives make unsolicited calls or visits to potential customers to promote products, and strategies whereby insurance products are sold as add-on products to or "bundled" with other financial or non-financial products – for example sold together with banking or credit products, or marketed through retail shopping outlets together with tangible consumer goods. In the case of direct unsolicited calls, the risk arises that the customer is "ambushed" into concluding a transaction without having adequate opportunity to consider their decision. In the case of bundled products, the risk arises that the customer is likely to be more focussed on their primary purchase and not pay sufficient attention to the details of the insurance product being purchased alongside the primary purchase. (See further discussion on the risks of add-on or bundled products in the discussion of *Governance of Product Design* in section 3.3 below).

Information asymmetries

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46. A perfect market implies perfect information for all parties involved, for instance regarding price, quality and the customer's needs, risks faced and circumstances. Information asymmetries arise where one party has better information or understanding of that information than the other. This is particularly relevant in regard to information held by customers, insurers and intermediaries respectively in the buying and selling of insurance.

47. Insurers and insurance intermediaries have the advantage of better knowledge of the characteristics of the products they sell and may even have better understanding of the risk profile of customers than the customers themselves. Consumers of insurance products all too often do not fully understand the products and services they buy. As a consequence they often do not give the right signals or provide incomplete information to insurers or intermediaries.

48. In the most developed insurance markets, insurance pricing has become extremely refined as insurers utilise big data and a variety of predictive analytical scoring models. The nature and extent of information asymmetry has grown in the insurers' favour with the advent of big data.

49. Financial product and service innovation – including the use of big data - can result in improved competition and more effective and efficient service offerings. However, innovation can also result in greater complexity of products and corresponding risks that products are not adequately understood. In addition to the growing complexity of insurance products, the distribution channels and servicing models for products have become more numerous and of different types. This adds to the complexities that face customers when trying to understand the environment in which they are buying a product and assess the range of products available to them.

50. In view of these complexities, disclosure alone may not be sufficient to address conduct risks arising from asymmetry. In some jurisdictions, supervisors and policy makers have recognised a need to adopt a more interventionist approach and change regulatory frameworks to address the inherent risks of information asymmetry. Such interventions include the setting of explicit product standards for products sold to less financially sophisticated customer groups, and the prohibition or limitation of certain types of distribution models for certain types of products.

51. Enhancing consumers' financial capability has been targeted as an international goal of the G20, leading to the publication of *High-level Principles on National Strategies for Financial Education* that were developed by the OECD International Network on Financial Education (OECD/INFE)[8].

52. Indeed, education plays a major role in enabling consumers to understand the information disclosed to them. Where financial literacy levels are low, the inherent information asymmetry between consumers and industry players is exacerbated, and the risks of exploitation of that asymmetry are increased. In addition, where consumers have low levels of financial literacy, the competitive benefits of innovation may be undermined, as customers may not be in a position to make informed choices. The aftermath of the financial crisis has shown how important financial literacy is, especially in an environment in which products have become more and more complex, with risks transferred to customers, sometimes in an opaque manner and involving an increasing number of stakeholders. Increasing financial capability thus can help to mitigate risks that arise from information asymmetries.

[8] http://www.oecd.org/finance/financial-education/OECD_INFE_High_Level_Principles_National_Strategies_Financial_Education_APEC.pdf

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53. The goal of financial literacy is to empower consumers with knowledge that will help their understanding of financial markets and products and so enhance their "market power". There are other approaches to increasing consumer market power as a means of promoting market discipline on insurers and intermediaries, including suitability of disclosure and requirements for and limitations of product design.

54. In order to address the gap in the traditional approach to financial education or literacy and so as not to provide a barrier to people when they need appropriate information, it is important that continued and easy access to all relevant information is available at the time when people have to make financial decisions.

55. However, due to the inherent complexity of insurance products and the limited time customers can devote to the study of detailed contracts, education cannot be considered as the panacea. Even well-educated customers can face difficulties in understanding product features. Therefore, disclosure and advice are of utmost importance during the underwriting process.

Consumer behaviour

56. Even when consumers are fully informed and capable of making a decision, behavioural biases can still lead to suboptimal results[9]. The consumer is not a *homo economicus* who always chooses the product or service that best suits his/her needs. Consumers will not necessarily make decisions that have entirely rational bases; sometimes other factors play a role in the decision, for example culture, intuition and emotion.

57. For many decades, economics relied on models that assumed people chose rationally: with normal capability, people would form accurate expectations about the likelihood of future events, and choose the product that best served their needs by assessing all relevant costs and benefits. The growing literature on behavioural economics shows not only that this is not the case, but also that some errors made by consumers are persistent and predictable. This raises the prospect of insurers and intermediaries designing business models to exploit these behaviours, rather than designing products and processes to mitigate risks arising from these behaviours.

58. Behavioural biases can be categorised in one of three ways. First would be "preferences", such as present bias, where the urge for immediate gratification values the present more highly than the future – an example would be over-borrowing: using a high interest short term loan to buy the latest tablet or mobile phone, without thinking how the loan would be repaid. Second would be "beliefs", such as over-confidence – for example, an excessive belief in one's ability to select winning stocks. Third would be "decision making" bias, such as persuasion and social influences – an example would be consumers allowing themselves to be persuaded to trust the sales person because he or she comes across as 'likeable' and therefore trustworthy, and thus relying on financial advice because the adviser is likeable, without giving weight to the effect of commission or other economic incentives for the adviser from the advice they receive.

59. While biases affect consumer choices in many different markets, there are several reasons why they are particularly likely to affect decisions in retail financial markets: most consumers find financial products complex; many financial decisions require assessing risk and uncertainty; financial decisions may require making trade-offs between the present and

[9] The UK's Financial Conduct Authority has conducted work in this area. See Occasional Paper No. 1: *Applying behavioural biases at the Financial Conduct Authority*, April 2013.

the future; many financial decisions are emotional; and it can be difficult to learn about financial products.

60. This can cause significant problems that financial markets, left to themselves, will not solve. A good example is payment protection insurance (PPI) in the UK (see Annex II) and similar products in other jurisdictions. Insurers were able to earn large profits on PPI products because many buyers fundamentally misunderstood PPI pricing and the limitations to its coverage. See Annex II.

3.2 Governance and business processes

61. One of the objectives of corporate governance by insurers and intermediaries is to protect the interests of policyholders.[10]

62. The governance framework has culture at its heart; this influences the way in which individuals behave. Where a culture of fair treatment of customers is not embedded within the business objectives and strategies, there is a higher risk that staff and management behaviour or business processes give rise to poor customer outcomes. The culture of an organisation needs to be set from the top (ie the Board and Senior Management).

63. In order to mitigate conduct of business risk, a culture of fair treatment needs to be sufficiently reflected in the governance framework and business objectives and strategies, with sufficient attention paid to ensuring fair customer outcomes in the corresponding policies, procedures, risk management and internal controls. In implementing a governance framework that promotes fair customer outcomes, the following are some of the key factors and areas that will be important:

- the entity's overall business objectives and strategies for achieving those objectives explicitly take customer outcomes into account
- the Board and Senior Management are sufficiently involved in and accountable for promoting good business conduct
- policies and procedures on managing conflicts of interests are adequate
- appropriate product design governance or, in the case of intermediaries, appropriate product selection processes, ensure that products are designed and promoted to be suitable to the needs of target markets
- remuneration and incentive policy sufficiently takes into account good customer outcomes
- staff at all appropriate levels are adequately trained in the organisation's commitment to good business conduct and what they need to do to ensure it is achieved
- recruitment, performance management, and disciplinary processes take customer outcomes into account.

64. Where insurers and intermediaries do not embed a culture of fair treatment of customers within their governance frameworks and business processes, there is a higher risk of poor customer outcomes. The culture of an organisation is reflected in its business model, strategy, incentives and decision-making processes. This message is also

[10] See ICP 7 in relation to insurers.

emphasised by The Financial Stability Board (FSB), which addresses business conduct as a key element of a sound risk culture[11]. Some of the key sources of risk are considered below.

Governance and risk management frameworks that do not adequately focus on conduct of business

65. In light of the historic supervisory emphasis on prudential risks, the governance processes of insurers and intermediaries tend to focus on financial aspects to a greater degree than customer facing aspects of the business. Risk management frameworks – including frameworks for internal and external audit and compliance monitoring – tend to focus on financial soundness risks to the entity itself, with less emphasis on risks posed to the insurer's and intermediary's customers (see further discussion in section 4 below). Related governance processes such as decision-making frameworks and delegations of authority also tend to be based on financial consequences to the entity, rather than the impact on the customer.

Conflicts of interest

66. Conflicts of interest can create barriers to good conduct, particularly where the insurance seller is in a stronger position than the buyer, for example in view of information asymmetries. Conflicts arise where the insurer or intermediary is subject to competing interests; a number of examples of situations in which these can arise are given in ICP 19.[12] Where personal interests, including incentives, compete with duties of care owed to customers, they can create risks that insurers and intermediaries will not act in customers' best interests.

67. Commissions and other sales incentives have been a particular source of concern. Risks increase where remuneration structures do not support fair treatment. Where incentives do not sufficiently take into account good customer outcomes as a factor, this can encourage behaviour by insurance intermediaries or the insurer's sales staff that is not in the best interest of their customers, for example recommending a product that would result in a higher commission or a salary bonus rather than one that best suits the customer's needs, or encouraging a customer to buy a product that they do not need.

68. Intermediary compensation structures which do not align the interests of the insurer and intermediary with the interest of the customer, for example by rewarding sales over long-term retention or suitability of the products, can result in unsuitable sales or unnecessary replacement of life insurance and savings products. Such compensation structures may put intermediaries under pressure to achieve sales results and "push" sales of products that customers might not need or afford. Furthermore, in efforts to ensure a sale, such intermediaries might advise customers to enter into lower priced products which offer lower protection than required.

69. The increased sophistication of some intermediary remuneration models, including contingent commissions, profit sharing arrangements, etc. further exacerbates the potential for conflicts of interest.

70. It is, however, not only the remuneration of insurance intermediaries or sales staff that may entail conflicts of interest. To support fair customer outcomes, it is important that

[11] See Section 1 above and FSB: Guidance on *Supervisory Interaction with Financial Institutions on Risk Culture*, *A Framework for Assessing Risk Culture*, 7 April 2014 (http://www.financialstabilityboard.org/wp-content/uploads/140407.pdf).

[12] See ICP 19.7

remuneration models across all relevant levels of the organisation do not conflict with customer interests.

71. Factors that may increase conflict of interest risks include:

- performance assessment and incentives being based on financial profitability and/or efficiency/productivity measures at the expense of customer outcome related measures
- lack of alignment between the incentives of senior management and those at lower levels of the organisation
- non-financial incentives, such as performance management, for sales staff being linked to sales targets rather than customer outcomes
- pressure to engage in cross-selling, including “add-on” products
- customer related performance targets being vague or too easily achievable, resulting in less focus on achieving these.

72. Remuneration models are not the only source of conflicts of interest that could result in sub-optimal outcomes for customers. Conflicts of interest can also arise as a result of the way in which the business relationships between insurers, intermediaries and their groups, or their relationships with other parties, are structured. This is not to suggest that these types of business relationships are necessarily problematic, but that particular risk mitigation measures may be required in these cases. Examples include:

- intra-group relationships where different entities within a group offer different products and services to the same customer base – for example where the group offers insurance, intermediation, and other products and services. This can support convenience and efficiency for customers, but can also lead to bundling of products and services in ways which can inhibit freedom of choice, add layers of cost, and sometimes entail conflicted advice
- shareholding and ownership arrangements can be such that the insurer or intermediary is incentivised (directly or indirectly) to act in the interests of shareholders or owners at the possible expense of customers. In particular, conflicts of interest can arise where an intermediary has an ownership interest in an insurer, or vice versa. Similar risks may arise from profit sharing or joint venture arrangements, particularly where the nature of such relationships and their associated incentives are not transparent or well understood by customers
- outsourcing relationships where, for example, services are outsourced by insurers to intermediaries in exchange for additional remuneration – resulting in intermediaries being incentivised to place business with those insurers where they have an opportunity to earn additional income. This may also create the risk of insurers paying outsourcing fees that are not in fact commensurate with the true cost of the outsourced services, in order to attract sales from the intermediaries concerned.

73. Self-placement practices can be another source of conflicts of interest. Some financial institutions sell financial instruments that they themselves have issued in order to comply with enhanced prudential requirements, to their own customer base. Such practices enable them to raise capital in a cheaper and easier way because of the captive nature of their customer base. This risk may be exacerbated within financial conglomerates when, for

example, insurers distribute financial instruments structured by banks in the same group to their customers through unit-linked policies.

74. The use of self-placement by insurers may also put customers at risk. These financial instruments are more likely to absorb losses first. Concerns also arise regarding the extent to which these conflicts are disclosed to or understood by customers.

Self-placement seen by the Joint Committee

To comply with Solvency II directive enhanced requirements, some insurers used self-placement practices. The three European supervisory authorities (ESAs), through their Joint Committee, carried out an analysis of the kind of breaches to consumer protection rules that are witnessed more accurately when these kinds of products are sold. Among other risks the customers can face, they are often given insufficient or misleading information about product characteristics, prices or risks. They may also be exposed to misleading marketing and advertising or unsuitable advice.

In this context, the Joint Committee in July 2014 issued a reminder to credit institutions and insurers about applicable regulatory requirements as regards self-placement.[13]

Governance of product design

75. The design of a product is the very first stage of the product's life. Product design is therefore of paramount importance as poor or inappropriately targeted product design has potential to result in material customer detriment.

76. In the product design and approval process, meeting customer needs and delivering on reasonable customer benefit expectations should be balanced against profitability or sales volume priorities.

77. Some insurance products are sold alongside, or as an add-on to, 'primary products'. This business model may also be referred to as "bundling" of insurance products with other products. These primary products may be financial services – e.g. home loans or other credit products, banking products, etc. – or they may be non-financial products – e.g. motor vehicles, mobile phones, furniture or services such as passenger flights. The add-on distribution model has a real impact on customer behaviour and affects the way people make decisions. Customers' attention is on the purchase of the primary product rather than the add-on, leading many to buy add-on products they do not need or understand. Buyers of add-on products are less likely to shop around and less price sensitive. They also have a poor awareness of whether or not they have bought insurance products. This risk is particularly high in relation to credit insurance, where the customer's priority is obtaining credit in order to take out a loan or to acquire an asset such as a property, vehicle or item of furniture on credit, and pays little heed to whether the insurance product that is "bundled" together with the credit offering is in fact appropriate to their needs.

78. Customers' ability to assess options and make choices is hindered by the fact that there is often insufficient information available about the quality and prices of add-ons, and what information is available is often presented very late. Add-on providers benefit from a clear point-of-sale advantage in comparison with standalone providers, which is reinforced by the way customers respond to the add-on option. There is little pressure on insurers or intermediaries to offer good value, and standalone products do not generally constrain sales

[13] See https://eiopa.europa.eu/Publications/Press%20Releases/2014-07-31_Joint_Committee_note_on_self_placement.pdf#search=self%20placement

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of add-ons. Analysis shows that this can lead to poor value, and to prices significantly above cost for many add-on products. Ineffective competition translates into consumers paying too much and receiving poor value when buying products distributed in this way.

79. In addition, the insurance industry is increasingly designing products aimed at purposes beyond mere risk coverage e.g. investment and money saving. These types of products may be complex, and their investment performance related risks may not easily be perceived by the average customer and may not be aligned to the customer's risk profile.

80. An "one size fits all" approach to product design and/or distribution also poses risk of poor customer outcomes where the insurer's product design process and distribution model do not take account of the needs of different target customer groups.

81. Where intermediaries are concerned, although they are typically not involved in product design, conduct of business risk arises where intermediaries do not do sufficient due diligence when selecting insurance products or insurers, in order to familiarise themselves with the product features and satisfy themselves that the products are suitable for the customers whom they will advise to purchase them.

Product oversight and governance (POG) – a European initiative

Work on POG was launched by the European Parliament to ensure that consumer protection issues are appropriately addressed in the processes that occur prior to the sale of the product. Product oversight and governance is defined as the responsibilities of manufacturers in organising processes, functions and strategies aimed at designing, operating and bringing products to market, and reviewing them over the life of the product. Product oversight and governance is distinct from product approval by regulators in the formal licensing or authorisation sense or regulatory interventions such as 'banning' (ie product intervention).

The Joint Committee of the three European Supervisory Authorities (ESAs) – comprising the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities and Markets Authority (ESMA) – was used to facilitate cooperation between the ESAs in this work. In 2013, the Committee issued high level principles on POG. The Joint Committee set several high level principles that encourage manufacturers to define a target market as well as a distribution channel. Manufacturers are able to limit the distribution to the target market or, where products are sold to customers outside the target market, ask the distributor to justify the sale. In addition, the manufacturer should periodically monitor the performance of the product to ensure that it continues to meet the objectives and interests of the target market as well as review the product, where appropriate, to ensure compliance.

Following the publication of these high level principles, the three ESAs became responsible for issuing guidelines on POG. Since then (in October 2014) EIOPA has published a consultation paper[14].

Poor underwriting practices

82. Poor underwriting practices could result in increased risk to the insurer. They could also result in customers not being treated fairly as the objective of proper risk assessment and accepting individual risks by charging premiums commensurate with the individual risk profile would also suffer, potentially impacting negatively on the interests of larger groups of customers. In some business models, no or minimal individual underwriting is carried out

[14] https://eiopa.europa.eu/Publications/Consultations/2014-10-27_EIOPA-BoS-14-150_POG_guidelines_rev.pdf#search=POG

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before policy issue, but insurers rely on standard health declarations and/or cover exclusion clauses to manage their underwriting risk. This practice, sometimes referred to as "underwriting at claim stage" may be appropriate in so-called "group underwriting" models, where a group of lives is insured collectively and individual up front underwriting would unreasonably increase the cost of cover. However, unless sufficient care is taken to ensure that customers fully understand the implications and scope of the declarations and/or exclusions concerned, this practice can lead to materially unfair outcomes with customers' benefit expectations not being met at the claim stage.

Quality of advice

83. Various situations, over and above the conflicts of interest discussed above, may result in inadequate or inappropriate advice being given to the customer, for example:

- sometimes advice is based on insufficient knowledge about the customer or inadequate documentation. Customer information that is gathered at the start of the relationship may be insufficient, not providing the adviser with enough information to understand the customer's needs and objectives
- processes leading to the provision of advice can sometimes be too formal and apparently in place only to satisfy regulatory requirements – a "tick the box" approach
- IT systems may not be sufficiently developed or adapted. This can be the case in particular regarding sales via the Internet, for instance where the questionnaire used to identify the consumer's circumstances creates unfair bias toward particular products or focuses on price to the exclusion of risks, benefits or other suitability criteria.

84. Where complex products are sold without advice or with poor quality advice, there can be a high risk of poor customer outcomes. Customers often do not adequately understand the features and consequences of complex products, and theseneed to be explained to them in a manner that takes the customer's financial capability levels into account, to avoid misunderstanding and outcomes that do not meet their expectations.

85. Risks arise where advice does not sufficiently take into account customers' circumstances, including their attitude towards risk.

86. There may be a "quantity over quality" approach to the advice process, where the customer is provided with large quantities of comprehensive information, without due regard to whether the information is appropriate to the customer's level of financial capability and is in fact understood. Requiring a customer to make a declaration that they understand information provided to them may not be an appropriate safeguard.

Insufficient knowledge, ability and experience of advisers or sales staff

87. Adequate product training is essential to ensure that advisers and sales staff have sufficient knowledge of the product. Where advisers do not understand the product adequately, this increases the risk and can result in mis-selling. Risk of mis-selling is further mitigated by appropriate experience and qualifications.

88. Intermediaries' and insurers' sales staff can have insufficient knowledge as regards business practices and their own obligation to adhere to consumer protection rules. This may result in them failing to follow the necessary procedures to respect consumers' rights. To be complete, training programs must deal sufficiently and appropriately with business practices and consumer protection issues.

89. Moreover, training needs to be maintained to ensure that knowledge, including specific product knowledge, remains current and does not become obsolete.

Advertising and product disclosure

90. Advertising is often the catalyst for contact between the customer and the insurer or intermediary. Its main purposes are to attract customers to a product, and to encourage them to purchase it. It is a key element in maintaining and growing the business. Supervisors have long been aware of the risks that inappropriate advertising and marketing practices can result in for customers.

91. There are risks when advertising or other pre-contractual material is not clear, not accurate or misleading, including when the presentation of risks against benefits is not balanced. Risk can also arise where different disclosure formats make insurance product features difficult to compare.

92. This pre-contractual phase is closely linked with the issues of information asymmetry discussed above. Disclosure material that is not designed with the financial capability of the target customer market in mind may fail to achieve its intended purpose.

93. Risk also arises where, after the sale, insufficient ongoing information is provided during the life of the product concerned, and there is failure to take adequate steps to monitor the customer's changing circumstances in order to assess the ongoing suitability of the product.

94. Insurers may view disclosure from a legalistic perspective – did documents provided to a consumer disclose all features of the product required to be disclosed? This legalistic perspective is generally less effective than one in which disclosures are drafted with the aim of empowering customers to make well informed purchase decisions whilst also fairly establishing customer expectations about the insurance product.

Key Information Document (KID)

Many new insurance products, particularly life products, are complex, making it difficult for consumers to understand the product characteristics. This has led some supervisors to introduce standardised disclosure documents (sometimes called a "Key Information Document", or "KID"), or to call for such templates to be developed. The European PRIIPs regulation (Packaged Retail and Insurance-based Investment Product) provides for a new disclosure template. A KID contains information such as the key features of the product, its risks, the costs and benefits.[15]

Poor claims management

95. As important as pre-contractual information, post-sale service has to be carefully considered as it can give rise to risks to insurers and customers. Claims management in particular has a prudential risk component as it can have a key impact on insurers' financial soundness, but fair claims management is also key to managing conduct of business risk.

96. As far as customers are concerned, this part of the contractual relationship is of utmost importance. To be adequately covered in case of a claim is the very aim of buying insurance. Therefore, there are then two main risks of failure to meet customer benefit

[15] Some information can be found on the European commission website: http://ec.europa.eu/finance/finservices-retail/investment_products/index_en.htm.

expectations: not to be covered for the risk related to the claim which the customer believed was covered, and to have an inappropriate or inadequate level of cover when risks materialise.

97. Besides insufficient cover, poor claims administration can in itself be a source of risk for customers. They can suffer for instance from unjustified delays or inadequate explanations provided by insurers or intermediaries in relation to claims decisions, at a time when they ae typically in a vulnerable or stressful situation.

98. Claims rejection data can be an early warning to detect deteriorating claims experience, indicating for instance weaknesses in the design of the product value proposition or mis-selling practices.

Outsourced processes[16]

99. Insurers and, to a somewhat lesser extent intermediaries, may outsource certain business process. The potential for conflicts of interest to arise from outsourcing, particularly outsourcing by insurers to intermediaries, has been discussed above. In addition, although outsourcing can be an effective efficiency driver, poorly priced outsourcing models pose the risk of additional costs being unfairly passed on to customers. A further conduct of business risk arising from outsourcing models is where insurers or intermediaries in effect "abdicate" responsibility for fair customer outcomes to the outsourced service provider, without sufficient controls in place to ensure fair customer treatment. This risk arises in particular where the insurer or intermediary does not ensure that it has adequate ongoing access to customer related information in order to enable it to monitor customer outcomes. Inadequate data protection and confidentiality controls within the outsource provider are also a key risk area,

Inadequate systems or operational business processes

100. Where an insurer's or intermediary's systems and processes are not adequate to ensure suitable levels of customer service, the risk of unfair customer treatment is increased. Examples include unreasonable obstacles to accessing funds, making claims or complaints, or accessing information. The risk of providing incorrect information and errors or delays in processing service transactions may be a direct consequence of weak operating systems.

3.3 Economic and environmental factors

Market-wide business practices

101. Market-wide business practices, such as prevalent product structures, distribution models, marketing strategies, etc. can have broad impact on a large number of customers. In many cases, supervisors will be aware of common market practices or business models that pose a risk of unfair customer outcomes if adequate governance and control measures are not in place to mitigate these risks. The extent to which a particular insurer or intermediary adopts such practices may therefore be an indicator of the conduct of business risk it poses. Examples are discussed elsewhere in this paper and in Annex II.

Economic / environmental factors and the structure of the market

102. The structure of the market and the levels of competition in the market may also be sources of conduct of business risk. For example where competition is fierce, insurers and intermediaries may seek to differentiate their offerings in ways that may pose risk to

[16] See ICP 2.13

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customers – such as by promoting add-on or "bundled" products or features that may not be necessary to the customer or may introduce hidden cost. Conversely, there are also risks where there is insufficient competition, for example in highly concentrated and/or interconnected markets, where conflict of interest risks are exacerbated.

103. Market structures and competition levels also pose potential risk to financial inclusion. In a saturated market, there may be an increased tendency to target new markets such as unsophisticated, previously excluded consumers. Care needs to be taken to ensure that aggressive marketing practices do not exploit the vulnerability of such consumers and that products sold are indeed appropriate to their needs. On the other hand, in a developing market with less competition, there is the risk that products may not offer adequate value for money due to lower levels of competition coupled with information asymmetry. In both scenarios, although products may be sold into previously under-served markets, there is a risk of true inclusion not being achieved as the products concerned may not deliver fair customer outcomes.

104. In various segments of financial services there is an increasing tendency to transfer risk to customers. These customers, with or without the support of an intermediary, are required to make financial decisions in order to achieve their goal(s) and fulfil their identified need(s), with products designed in such a way that the risk of poor decisions is borne by the customer. For example, retirement savings and investment products where the customer chooses underlying investment portfolios and benefits are solely dependent on the performance of these chosen portfolios. Within this decision making process, assumptions on often unpredictable economic factors such as future interest or inflation rates often need to be made by ordinary customers.

105. Assumptions are also important form an insurer's perspective, for instance with regard to longevity risk. Although this is primarily a prudential risk it will ultimately have an impact on consumers as well. If assumptions turn out to be wrong, consumers have a product that may no longer be sustained and therefore will not fulfil their need. One possible example in this area is long term savings policies or life annuities. Since this product typically has a long term focus, potential detriment could be significant. The greater the levels of economic uncertainty and volatility, the greater the risk inherent in products whose performance is linked to these assumptions.

106. Irrespective of the stage of development of a specific market, economic factors also interact with the demand for financial products by themselves. For instance, a recession can result in over-indebtedness increasing the risk of consumers making poor financial product decisions (either to enter into additional debt or to cancel policies and cash in investments inappropriately), as well as the risk of exploitation of these vulnerable consumers. On the other hand, in periods of economic success, where credit may be more readily available and consumers may be overly optimistic regarding their financial capability and prospects, the risk of consumers making poor financial decisions and being lured into unsustainable products is increased.

Legal/regulatory environment

107. To encourage financial sector development that supports fair customer outcomes, the legal and regulatory environment should provide a framework that enables the development of sustainable and competitive markets, supports customer value-enhancing innovation, facilitates monitoring and enforcement of rules, and ensures consumer protection. Unregulated or inadequately regulated and/or supervised financial services providers significantly increase the risk that consumers face fraud, abuse and misconduct.

On the one hand, gaps within as well as between regulatory frameworks can lead to regulatory arbitrage. On the other hand, inflexible or too detailed regulation can also give rise to conduct of business risk since this can create a 'tick-box' type of compliance instead of a mind-set focussed on fair customer outcomes. Too detailed regulation can also lead to unreasonable barriers to new entrants, and therefore hinder market competition and financial inclusion.

Technology

108. Technological developments reduce the importance of actual physical accessibility of financial service providers. At the same time, technological solutions that create a perception of personal proximity are becoming ever more prevalent. A wider range of financial products and services as well as financial online tools and applications are becoming available. There is also more information on products and services than ever before. New technology enables insurers, intermediaries and other financial service providers to customise products and marketing material. Using comparison websites to find an alternative product or switching from one insurance company or other provider to another can be arranged within minutes. However, more opportunities and fewer barriers do not automatically mean better market or customer outcomes and can give rise to conduct of business risks.

109. For instance, comparison websites create risks that consumers select products solely based on price, with insufficient regard to the appropriateness of product features to their needs. In addition, there is a risk that complex products are being sold online or using digital platforms without appropriate advice. In line with the developments from a technological perspective, data is more and more considered as a valuable asset in itself. Financial services become more and more data driven. This growing importance of data leads to risks from a privacy protection perspective as well as from a data security perspective. Sophisticated cyber-attacks lead to customer data being stolen, manipulated or destroyed.

110. These developments pose supervisory and regulatory challenges. Supervisors need to adapt, to foresee potential risks, and to act in a timely and appropriate manner to pre-empt emerging conduct of business risks. The regulatory framework needs to adapt as well, since this framework is based on the current situation and existing supervisory methods.

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4. Conduct risk management

111. It is important that risk management frameworks are designed to adequately identify, monitor and mitigate all relevant classes of risk, whether prudential or conduct related[17]. An insurer's risk management system should take into account all reasonably foreseeable and relevant material risks to which the insurer is exposed, at both the level of the specific regulated entity and the broader group where relevant. This includes current and emerging risks.[18] An appropriate risk management framework needs to ensure that all risks posed to or by an insurer are managed holistically, at all stages of the insurance product life cycle, from before a contract is entered into through to the point at which all obligations under the contract have been satisfied. Following a holistic approach means that conduct of business risks are fully integrated into the insurer's risk management.

112. Customer complaints and disputes can be time-consuming and costly. Consumers' loss of confidence may damage an individual insurer or intermediary or ultimately part or the whole of the insurance sector. Furthermore, where insurers and intermediaries do not act with due skill, care and diligence when dealing with customers,[19] non-compliance itself represents a compliance and reputational risk. For these reasons conduct of business risks need appropriate attention within the risk management framework.

113. It is important that risk management is an ongoing process. Risks need to be regularly monitored and assessed, as they change over time. Similarly risk mitigation mechanisms (including relevant policies and procedures, training and competence requirements etc.) need to be maintained and subject to appropriate evidence and documentation.

114. Where conduct of business risks are concerned, a holistic risk management framework needs to recognise that insurers may wish to review the current risk frameworks they use to determine if they are appropriate for identifying and managing conduct of business risks. Particularly in jurisdictions where risk management has historically been focussed primarily on prudential risks, some changes to the risk management approach are likely to be required.

115. The need to review risk management frameworks to address conduct of business risk, may include a review of the risk classification or risk taxonomy used , to ensure that the classification or taxonomy enables adequate focus on conduct of business risks. The classification of risk is important, as it will dictate the type of risk mitigation measures applied.

116. For example, to the extent that conduct of business risks are currently addressed in risk management frameworks, these risks are typically classified under "operational" risks. They are less frequently considered under "strategic" risks (where such a category is used). As a result, there is a risk that customer interests are addressed at an operational level, without paying due regard to the customer implications of the insurer's or intermediary's broad strategic goals. An exclusively operational focus on customer outcomes may result in an entity focusing its risk mitigation efforts on addressing issues of customer service efficiency and transactional processes, without necessarily addressing customer outcomes when setting strategy, designing products and distribution models, etc.

[17] See ICP 8. Although the ICPs do not specifically address risk management frameworks in relation to intermediaries, and the paragraphs which follow therefore focus mainly on insurers, supervisors may wish to consider the extent to which intermediaries' achievement of the outcomes of ICP 18 and 19 would be strengthened through appropriate risk management frameworks

[18] See ICP 8.1.

[19] See ICP 19.1.

117. Conduct of business risks may also be viewed under the heading of "reputational" risk. This is understandable as poor customer experience can clearly impact negatively on an insurer's or intermediary's reputation. However, where conduct matters are viewed only from this perspective, it is possible that risk mitigation efforts will be aimed mainly at protecting the reputation of the organisation (for example through public relations interventions), without necessarily improving customer outcomes or ensuring appropriate customer redress.

118. Another relatively common classification of conduct related risks is to regard them as "legal or regulatory" risks. This is because regulatory frameworks typically impose specific customer protection obligations on insurers and intermediaries, with contraventions of these triggering potential regulatory action or sanctions. Where conduct of business risks are viewed mainly from this perspective, there is potential for a "tick the box" approach to managing these risks, with entities focussing mainly on achieving minimum regulatory compliance rather than fully considering customer outcomes across their business and ensuring that a culture of fair treatment is embedded.

119. It is not the intention of this paper to propose that insurers and intermediaries should necessarily change the risk classification or risk taxonomies they use in order to accommodate conduct of business risks. Rather, the discussion above is intended to highlight the need for insurers and intermediaries to carefully consider how best to accommodate conduct of business risk in whatever risk management framework they have adopted – and to highlight the fact that traditional frameworks may not always lead to the most effective risk identification and risk mitigation actions.

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5. Supervisor's role

120. In accordance with ICP 1, "the principal objectives of supervision promote the maintenance of a fair, safe and stable insurance sector for the benefit and protection of policyholders."[20] To achieve this, one or more supervisory authorities are given responsibility for supervising the manner in which the insurance sector conducts insurance business in relation to consumers and policyholders.

121. In cases where conduct of business supervision and prudential supervision are allocated to different supervisors (for example in so called "Twin Peaks" supervision models), it is important that appropriate co-ordination arrangements are established between the two authorities to ensure a holistic approach to assessing the totality of an insurer or intermediary's risk profile . However, also in cases where conduct of business and prudential supervision resides within an integrated supervisor, co-ordination may be required between different departments or staff who may have a different focus. Co-ordination is also important where the supervision of insurers and intermediaries respectively is allocated to different supervisors (or different departments or staff within the same supervisor), as conduct of business risks may be detected by assessing the nature of the relationships between insurers and intermediaries, and not necessarily from the conduct of each of them when viewed separately.

122. Cooperation on conduct-related matters at international level may also be important, as the market in a jurisdiction can be affected by both conduct and prudential issues in another jurisdiction.

5.1 Supervisory requirements and approaches

123. Conduct of business supervision addresses the balance between consumers and the insurance industry by requiring insurers and intermediaries to consider the best interest of their customers, enhancing consumer trust and confidence and hence promoting insurance market stability. It is not the purpose of this paper to set out supervisory requirements in respect of conduct of business. These are addressed in other IAIS literature, primarily ICP 19 (Conduct of Business), ICP 18 (Intermediaries), ICP 8 (Risk Management and Internal Controls) and ICP 9 (Supervisory Review and Reporting). A number of other ICPs contribute towards mitigating conduct of business risks through their requirements, inter alia, in respect of licensing and governance.

124. Where insurers are concerned, the COB Supervision Paper provides a considerable amount of supporting material in respect of how conduct of business requirements can be addressed through the supervisory process, including in the course of off-site monitoring and on-site inspection.

Key factors for a conduct of business risk-based supervisory framework

125. The supervisory framework needs to provide the supervisor with a holistic view of all risks to which an insurer is exposed, as well as risks posed by the insurer and/or the intermediary, at all stages of the insurance product life cycle. Jurisdictions should have risk-based approaches (used by the supervisor and/or insurers) that are appropriate for identifying and managing conduct of business risks. Supervisors need to take conduct of business risks into account in assessing the 'riskiness' of insurers and intermediaries, including creating conduct of business risk profiles and incorporating conduct of business risks within a risk-based approach.

[20] See ICP 1.3.

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126. Conduct of business supervision can benefit from a forward-looking approach that seeks to identify and address potential risks at an early stage, before they become significant. This involves making forward-looking judgements regarding the likelihood of conduct of business risks crystallising and the most effective supervisory response to pre-empt customer prejudice[21].

127. Mitigating conduct risk should apply at all stages of supervision – from initial licensing through to on-site inspections and off-site monitoring, thematic supervisory work, data collection/reporting, through to enforcement[22].

Prudential and conduct of business supervision: Complementary approaches

128. As pointed out in the COB Supervision paper, conduct of business supervision requires a different set of knowledge, skills and abilities to prudential supervision, including a strong understanding of topics such as:

- insurance law and regulations
- general consumer protection practices
- insurance business models, products and practices
- best practices and risks related to fair treatment of consumers.

129. The requirements and expertise used in prudential supervision provide supervisors with a significant amount of information on insurers' financial health. This information can also be useful to conduct of business supervision.

130. Conversely, conduct of business supervision can play a role in early detection of issues that could affect the financial strength of an insurer, and provide an important input into prudential supervision. For example, aggressive or misleading business practices can be symptoms of insufficient control over distribution channels. They can also be signs of inappropriate governance or ineffective internal controls. Ultimately such issues can trigger financial difficulties where insurers need to reassess existing commitments or redress the mis-selling of products. As discussed earlier, inappropriate remuneration and incentive policies can lead to the selling of products that do not deliver fair outcomes, although the discovery and consequences of mis-selling may only arise in the future.

131. The linkage between conduct of business oversight and prudential oversight will facilitate a holistic evaluation of whether the insurance sector is delivering desired customer outcomes and desired broader market outcomes. Currently, prudential supervision is largely unlinked to and not informed by conduct of business outcomes. The goal of prudential oversight is to minimise the likelihood of an insurer failure. Since such failures are rare, prudential oversight focuses on high level policies and procedures for insurer operation as opposed to focusing on data that evidences customer outcomes. In contrast, in addition to reviewing policies and procedures, conduct of business oversight often involves review of a myriad of day to day business practices, such as sales, claims and complaints processes and data. This information in turn can be used on an aggregated basis to monitor market outcomes and assess market wide conduct of business risks.

132. Corporate governance and risk management oversight, from the prudential regulatory perspective, evaluates insurer processes based on the premise that good processes will produce favourable outcomes for consumers and the market. The problem is that there are not necessarily mechanisms in place to assess whether this linkage is

[21] See also ICP 9.2
[22] See also ICP 9.2

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transmitting properly - ie that "good processes" indeed produce good outcomes. Some supervisors have adopted granular market surveillance in a variety of forms to evaluate customer and market outcomes in order to assess the effectiveness of insurer governance and risk management processes. Such detailed conduct of business outcome analyses may be helpful in assisting prudential regulators, who may otherwise have difficulty differentiating between governance processes that are truly effective and those that are not.

5.2 Risk identification and monitoring

133. As indicated in the COB Supervision paper, and in section 2 of this Issues Paper, conduct of business risk indicators will be different from, or additional to, those used for prudential supervision, in order to be effective in identifying conduct risks. This applies not only to risk indicators used by insurers and intermediaries themselves, but also to the risk indicators monitored by the supervisor. A list of potential conduct of business risk indicators is included in Annex I.

134. Conduct of business supervision should comprise a balance of qualitative and quantitative information. In addition, conduct of business supervision requires sufficient quantitative financial expertise to “follow the money”. In order to understand the drivers of culture and behaviour in organisations, it is important to understand drivers of profit and cost

135. In identifying and monitoring conduct of business risk, supervisors need to take an overall view of conduct of business risk indicators – some examples of which are listed in Annex 1. The supervisory approach will go beyond the insurer or intermediary- specific factors and include a review of the broader external risk sources discussed in section 3.3 above. These broader reviews may include macroeconomic analysis, as well as market analysis to understand new market wide trends and developments (such as new product or distribution strategies). Analysis of relevant market wide data (such as the types and sources of complaints handled by alternative dispute resolution structures), to identify sector or sub-sector risks, may also be used as a basis for supervisory action. The results from market monitoring and other information sources should provide feedback into the supervisory approach.

136. Supervisors may also take into account thinking from the field of behavioural economics, to assess the risk of poor customer outcomes.

5.3 Communication on conduct of business risk by the supervisor

Publication of forward-looking risk assessments

137. As highlighted in the COB Supervision paper, some supervisors take a forward-looking approach to conduct of business risks and publish an assessment of the risks foreseen as emerging in the near to medium term, typically over the next 12 or 18 months, together with the likely supervisory action should those risks crystallise. The assessment may also include an explicit message concerning the supervisor’s expectations of how insurers and intermediaries should engage with and react to the analysis contained in such a risk assessment. Such risk assessments could include both risks arising from the business models and practices of insurers and other financial institutions, as well as risks arising from broader economic, regulatory or other external developments. This assessment should be communicated to industry and the public and may include communication on perceived risks, and supervisory expectations on how the supervisory objectives will be met.

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Example from United Kingdom: Risk Outlook

In 2013 and 2014 the UK's Financial Conduct Authority (FCA) has published an annual Risk Outlook. These publications set out the FCA's views on the conduct and prudential landscape for the firms it regulates. It looks at the causes of risks and how these affect consumers, and uses this to prioritise areas of supervisory focus in the future.[23]

138. Proactively highlighting potential risks and areas of concern can encourage insurers and intermediaries to take these into account, and can help to stop the issues from becoming major problems. In addition, where the supervisor has proactively drawn the industry's attention to potential areas of concern, such as business practices that it has identified as potentially leading to poor customer outcomes this may, subject to the regulatory framework in the jurisdiction concerned, strengthen the supervisor's hand if subsequent enforcement action becomes necessary. Where the supervisor's concerns have been clearly signalled, an insurer or intermediary who has not taken account of these concerns and has persisted with the business practices concerned is less likely to be able to defend its actions and challenge the supervisor's intervention if those practices do in fact result in poor outcomes.

Supervisory expectations

139. Supervisors communicate their expectations to industry on conduct of business practices through a variety of means ranging from formal to informal approaches. This can often involve issuing forms of guidance that may be binding, non-binding guidance, or binding but not necessarily subject to the same enforcement processes as explicit rules-based requirements. Guidance is a very useful tool for conduct supervisors to try to influence industry behaviour and to explain expectations regarding rules that are not as quantitative as prudential rules. Examples include:

- "Dear CEO" letters
- information letters
- formal guidance (eg in the form of directives, official notices, circulars)
- recommendations or best practices on how to address specific topics (eg claims or complaints handling).

Such guidance, even where it is non-binding, can be a useful tool for avoiding disputes as to the regulator's expectations in the event that formal enforcement action is required, particularly in the case of principles-based requirements.

140. Other mechanisms for communication on supervisory expectations include:

- meetings with management
- on-site inspections, including follow-up meetings and communications
- newsletters
- events hosted by the supervisor or industry, professional or consumer associations events.

[23] See http://www.fca.org.uk/ for further information.

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> ***Example from France: Initiative to influence corporate governance***
>
> In France, insurance companies must fulfil on-going reporting requirements on their business practices that include completing an annual "Questionnaire on business practices". This questionnaire helps insurers to better understand the French Prudential Supervision and Resolution Authority (ACPR)'s expectations on consumer protection matters and to reflect consumer protection requirements within their internal control systems.
>
> The questionnaire covers insurers' procedures and processes on various issues (for instance, conflicts of interest and remuneration, claims, complaints).
>
> It is based on a self-assessment, and as such provides an occasion for insurers to assess their compliance with business practices rules. Moreover, it offers an opportunity for insurers to examine their corporate culture regarding consumer protection.

Public disclosure by the supervisor

141. Some supervisors publish conduct-related information that can help to mitigate risks to consumers. Such information might include:

- warnings (e.g. in relation to insurers or intermediaries operating without a licence, suspicions of fraud or other financial crime, potential abusive selling practices)
- supervisory action taken (including enforcement action)
- general information related to financial services products and their distribution that seeks to enhance consumer awareness
- data on individual insurers' performance in relation to appropriate conduct indicators or benchmarks – such as complaints or claims related data - that can act as a deterrent to unfair customer treatment.

> ***Example from France: Warning the public on potential risks***
>
> The ACPR operates a common gateway, together with the French financial markets regulator (AMF) and the Banque de France that provides information and guidance to consumers. Under the name of "Assurance Banque Epargne Info Service" (ABE IS), it comprises a website (www.abe-infoservice.fr) and a helpline that provides general information about financial products, contracts and services, and on procedures for dealing with disputes. The website is also intended to warn the public where poor conduct practices have been identified in particular institutions. The ACPR can also issue warnings to the public directly.
>
> Additional means of communication used by the ACPR include such as its bimonthly publication (*La Revue de l'ACPR*), and its annual conference.
>
> *Communication with industry*
>
> The ACPR is able to issue recommendations to guide the industry in the way it must apply the law and regulatory requirements. These soft law instruments are a good way to avoid potential risks to occur and be detrimental to consumers.

6. Conclusion

142. This Issues Paper demonstrates that prudential and conduct of business risks are closely linked but also differ in important ways and need to be managed, mitigated and supervised in a holistic manner. It builds on the new focus on conduct risks at the global level, as evidenced by publications of the FSB, the OECD and others.

143. The Issues Paper elaborates on ICPs 18, 19 and other relevant ICPs, and it provides a number of key messages:

- the recent financial crisis has highlighted that poor conduct of business can give rise to systemic risks
- mitigating conduct of business risks and promoting fair conduct of business practices contributes to increased customer trust that insurers and insurance intermediaries will treat them fairly, so contributing to confidence in the financial market as a whole
- there are key differences between conduct of business and prudential risks that require different and complementary approaches to risk management and supervision.
- conduct of business risk includes risks arising from poor business conduct to which insurers, intermediaries and the insurance sector itself are exposed, but importantly also risks to which insurers and intermediaries expose their customers
- conduct of business risk can arise from multiple sources, including inherent factors, the insurer's or intermediary's governance and business processes, and broader economic and environmental factors
- conduct of business risk, and all its components and sources, needs to be considered within the overall risk framework of, and risk management by, insurers and intermediaries
- the supervisory framework needs to provide the supervisor with a holistic view of all risks to which an insurer or intermediary is exposed, as well as risks posed by them
- conduct of business supervision goes beyond prudential supervision as it does not only consider the risks transferred to the insurer, but also the risks remaining at customer level or in some cases transferred to the customer
- conduct of business risk indicators differ from - but may complement - prudential risk indicators, and may be used to assess risks to customer and market outcomes at both individual entity level and broader market wide level
- where conduct of business supervision and prudential supervision are allocated to different supervisors, nationally or internationally, or to different departments within an integrated supervisor, it is important that appropriate co-ordination arrangements are established
- supervisors have a role to play in communicating conduct of business risks and their expectations, to both consumers and the industry

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Annex I

Conduct of business risk indicators or 'red flags'

The conduct of business risk indicators in this annex reflects the categorisation of the sources of conduct of business risk in section 3, into 'inherent factors", "governance and business process", and "economic and environmental factors". In addition it lists conduct of business risk indicators originating from the insurer that supervisors may use and external risk indicators.

Inherent factors		
Indicator	Measures	Implication
Profit level	• New Business Value • Accident/Underwriting Year profit	High profit may indicate products which offer poor value to consumers or may indicate high incentives for inappropriate sales or marketing behaviours.
Commission levels	Percentage of Annual Gross Written Premium	High commission level may lead to misleading and aggressive selling practices.
Low financial capability of consumer		Consumers with lower financial capability may be more vulnerable and in greater need of advice or protection.
Governance and Business Process		
Complaints	• Number of complaints • Resolution rates • Number escalated to the supervisor, alternative dispute resolution schemes, or other channels • Turnaround times for resolution of complaints • Number of complaints that have resulted in litigation • Nature of the complaints • Number and cause of complaints relating to claims • Number and value of claims resulting in litigation	High levels of complaints may indicate conduct issues. It will be important that new themes are investigated promptly. From an efficient complaints analysis the supervisor can detect potential problems on both individual company and industry-wide levels. Complaint information can serve as an early warning system to detect problems (including potential risk mitigation problems) and to provide a basis for further conduct of business review

Lapses/Surrenders	• Difference/Ratio between the expected numbers of surrenders vs. actual number of surrenders.	High levels of lapses, especially early lapses, may indicate poor product design or high pressure sales.
Claims management	• Number and value of rejected claims, including reasons for rejections • Number and value of claims resulting in litigation • Number and cause of complaints relating to claims • Number, age and value of outstanding claims	Very low levels of claims relative to premiums may indicate value or conduct issues. Low claims ratios may suggest high volume of refused claims, which may indicate mis-selling or bad wording of the contract Loss ratio information identifies companies with more claims then the norm. Significant deviations from the norm could indicate financial stress if the loss ratio is too high—or highlight the potential concerns about claims-handling or underwriting practices, if the loss ratio is unusually low.
Sales incentives/targets	• Remuneration policy for relevant staff • Performance management criteria	• Where remuneration policy includes a high variable component (e.g. bonus or commission component) related to sales (e.g. volumes) this may lead to unfair and aggressive selling practices • Where compensation is front-loaded, there could be little or no incentive for ongoing ownership of the product or customer satisfaction • Performance criteria or sales targets which are too aggressive could lead to mis-selling
Increasing claim provisions compared to incurred losses	Claims provisions / loss payment	A spike in provisions can occur for a number of reasons, some of which might signal conduct of business problems. A spike in provisions without a corresponding change in claims paid should be investigated
Sales to consumers outside the target market	Number of target sales as a percentage of total products sold	This could be a consequence of targeting the wrong market (meaning there may be a need for product design changes) or mis- selling
Contract changes		It could give rise to poor customer outcomes if contract terms change during the duration of the contract

Economic and Environmental Factors		
Growth level	• Change in Gross Written premium • Change of the market share in a given segment	High growth (historic and planned) may be an indicator of aggressive selling practices, but also a consequence of a really good consumer policies
Cost Cutting	Ongoing policy administrations costs /Gross Written Premium	Significant cuts in cost may impact service or operational resilience levels to the detriment of consumers
Changes in distribution models / intermediary remuneration practices	Changes in sales volumes or complaints by product line	Any significant changes in this regard can cause harm/detriment to customers due to lack of preparation for Insurer's policy changes
Herding effect in specific line/product	Insurance market data by product line	Customers may be driven to purchase products which are not suitable. If an insurer or the market is stressed, they may surrender policies at the loss of long-term benefits
Supervisors' sources originating from the insurer		
On-site and off-site inspections		
Reporting obligations	Mandatory reporting on business practices	This is a good way of gathering information on the market and its actors.
Sources external to the insurer		
Monitoring of advertising	Daily monitoring of advertising material issued by insurers	As advertising is often is first contact between a customer and a product (and thus between a customer and an insurer), it is useful to monitor it in order to detect violations of the consumer protection rules. Monitoring advertising is an opportunity for supervisor to identify new products, new distribution practices and to follow financial innovation to have a pro-active approach.

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Gathering of market trends and outcomes	• Formal or informal dialogue with consumer associations and other professionals • Meetings with other public bodies or regulators • Whistle-blowers and media monitoring • Consumer trends • Customer satisfaction survey data	Less formal input are needed to gather the trends and practices of the market through all kind of sources.

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Annex II

Example

Example from United Kingdom: Payment Protection Insurance

The PPI product

Payment Protection Insurance (PPI) was sold to borrowers alongside credit products. It was meant to help repay some or all of their borrowing if they lost their income for a period (if, for example, they had an accident, became unemployed or sick, or died). The most commonly sold types of PPI were single premium policies on unsecured loans (around 48% of all PPI policies sold), credit card PPI (around 36%), and regular premium policies on loans or mortgages (around 15%). PPI was not a simple product. It had complex pricing (premiums) and benefits, and detailed policy conditions (including eligibility criteria, exclusions from cover and limitations to benefits). Such details meant that PPI was suitable for some consumers but not suitable for all. Firms should therefore have exercised particular care when trying to sell it.

PPI mis-selling and the FSA's actions

For reasons that were eventually set out in detail by the Competition Commission, PPI proved highly profitable to the firms who sold it (particularly in its single premium form). Too many firms too often failed to give a balanced presentation of the product's pros and cons, or to ensure that a policy was suitable for the consumer's needs. As a result, PPI sales grew rapidly through the 1990s, peaking in 2004. Between 1990 and 2010, around 45m policies were sold, worth £44bn in premiums.

Around two thirds of these PPI sales were made before the Financial Services Authority (FSA) – the predecessor to the Financial Conduct Authority (FCA) – took on the regulation of non-life insurance selling (on 14 January 2005). The FSA was aware from the outset of potential issues with PPI, but believed its new regime for non-life insurance sales would address the concerns that had been raised. The FSA assessed firms' compliance with the new requirements in a thematic review of PPI selling practices in 2005. This identified and set out significant shortcomings in many firms.

During 2006-08, the FSA conducted further extensive reviews (including major mystery shopping exercises) across all sectors of the PPI market. The FSA issued three further updates, explaining the continuing, mainly disappointing, findings from its reviews. The FSA also took enforcement action against 28 firms and seven individuals, with each Final Notice detailing the firms' sales failings and imposing fines.

The extensive selling of PPI finally contracted in early 2009, when the FSA secured an agreement from the industry that it would immediately stop selling single premium PPI. This came ahead of the Competition Commission's proposed prohibitions on selling single premium policies and on selling any PPI at the same time as a credit product. More targeted selling of regular premium protection policies has continued since 2009. Such policies can still meet some consumers' genuine credit protection needs.

The FSA's PPI work then focused on ensuring that firms gave fair assessment, and, where appropriate, fair redress, to consumers who complained they had been mis-sold PPI. In August 2010, the FSA introduced additional measures to improve significantly firms'

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handling of PPI complaints. The banking industry challenged these measures in the High Court, but this was unsuccessful, and from April 2011, the FSA's supervisory work was able to move forward. The FSA began reviewing whether firms had successfully embedded the new measures and were generating fair outcomes for consumers' PPI complaints.

Lessons learned by the FCA

In hindsight, the profits generated for PPI sellers were so large that the FSA's warnings and fines were not enough to change firms' behaviour. We factored this conclusion, and other important lessons from the PPI story, into the design and approach of the new Financial Conduct Authority (launched in April 2013). The FCA has discussed these changes at length in previous publications, but, to summarise, we learned that we needed to:

- conduct more market analysis, so we can reach a better understanding of whether markets are operating well and of how best to resolve any market problems we identify
- seek out the root causes of problems and deal with them at an early stage, because prevention is better than cure
- make more use of our regulatory judgement
- promote competition in the interests of consumers, which will enable us to take a wider range of more effective actions to address complex issues like PPI in future
- look more closely at the risks to consumers from products' features and design, including restricting their availability where this is necessary to protect consumers
- pursue a more intrusive supervisory framework which closely examines the largest firms' business models (to see where they are making profits or seeking growth), culture (to ensure this puts consumers at the heart of the business model), and financial incentives to staff (an important potential driver of mis-selling) and
- engage more directly with consumers and their representatives, so we can understand their concerns, and be more informed about consumers' actual behaviour.

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