MILLIMAN RESEARCH REPORT

Global developments in conduct risk management

Summary report

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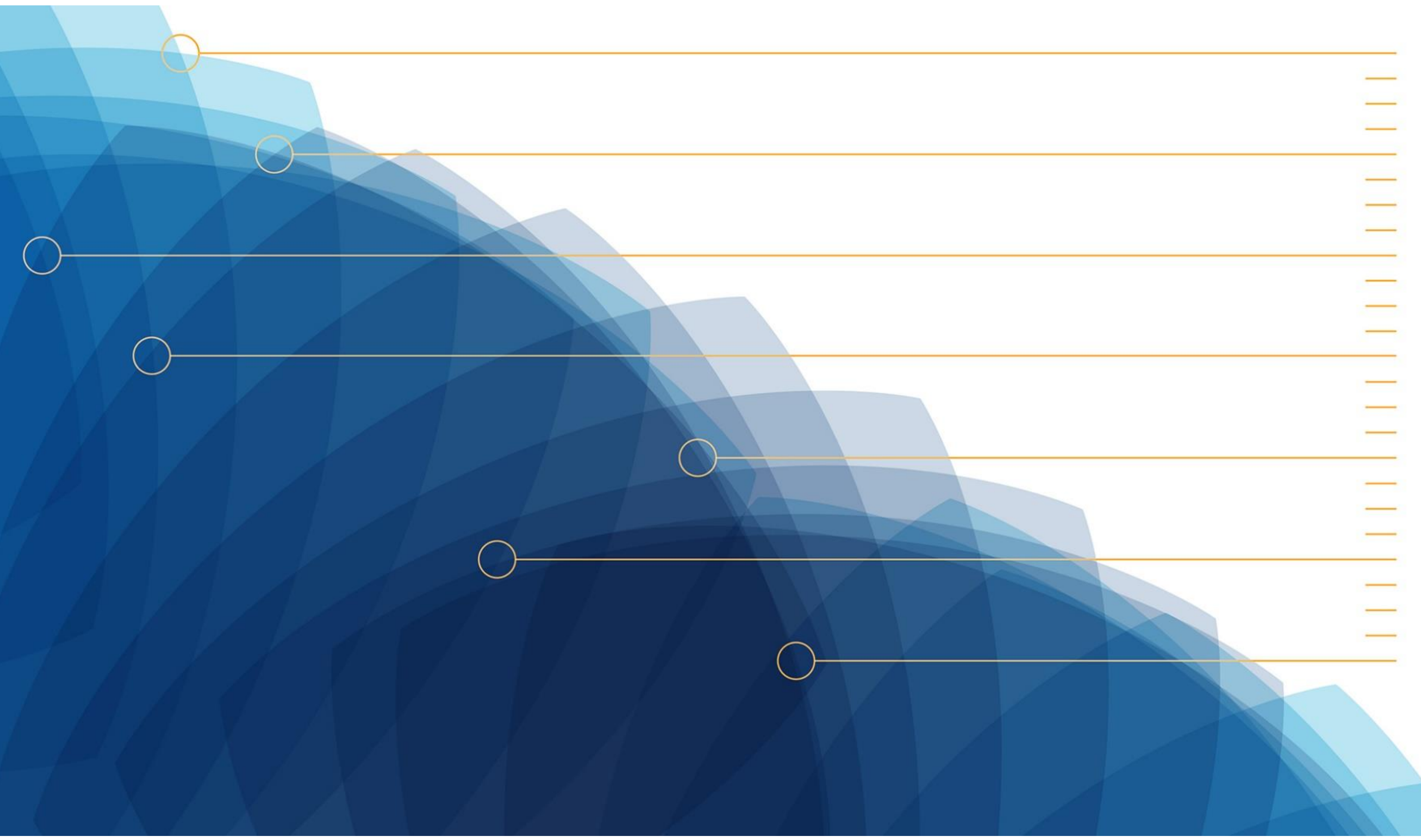
Karl Murray, FSAI
Eamonn Phelan, FSAI



In recent years prudential regulatory matters have been pushed to the fore across the financial sector. Historically regulators sought to protect customer interests mainly by focussing on the financial soundness of firms. More recently a more explicit focus has been placed on what is generally referred to as 'conduct of business' practices, with a view to ensuring that institutions are acting in their customers' best interests and treating them fairly.

The International Association of Insurance Supervisors (IAIS) has stated:

> *Conduct of Business supervision, in particular, requires a considerable focus on principles, outcomes and governance frameworks over and above compliance with specific rules. This is because it encompasses:*
>
> - *A broad range of insurer activities throughout the insurance product life-cycle*
> - *A broad range of insurer activities across the insurance value chain*
> - *Assessment of the insurer's customer treatment culture*

The same can be said across the financial services industry.

Conduct risk has been defined by a number of organisations in slightly varying ways but a succinct and salient definition is provided by the IAIS 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.*

The IAIS goes on to state:

> *This description includes the risks to which insurers, intermediaries and the insurance sector may be exposed as a result of their poor business conduct, as well as the risks to which such conduct exposes their customers.*

These specifications are a useful foundation for the consideration of conduct risk right across financial services firms.

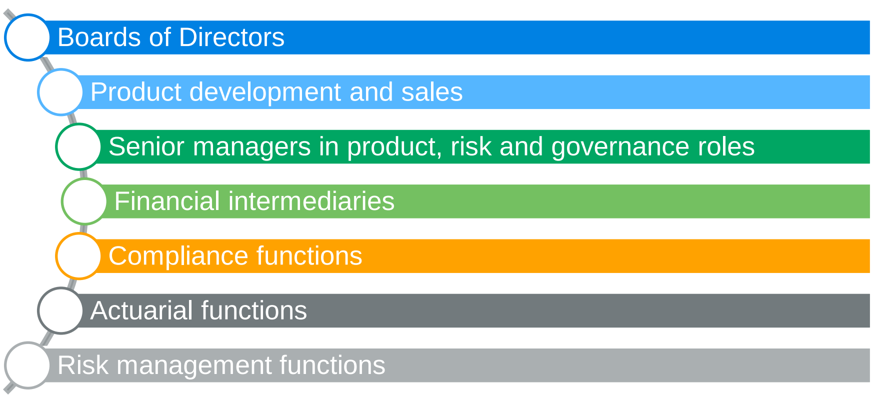
CONDUCT RISK

Risks relating to conduct of business are attracting increased attention across financial services firms, prompted by the ever-increasing focus of regulators in this area. In this paper, we take a closer look at recent and ongoing developments from around the globe.

Many large financial services firms are now working to embed conduct risk management practices within their wider risk management frameworks, with a view to taking a consistent approach across their business units. Effective management of conduct risk is seen as a key component of strategy, with the potential to reap benefits as well as avoid costs such as fines, redress payments or reputational damage. Well-managed responses to risk events also allow firms to demonstrate their commitment to positive customer outcomes.

Personal accountability is also an emerging theme. Staff in financial services businesses need to take ownership of conduct risk management and, in turn, incentive and remuneration structures need to support this activity.

FIGURE 1: ROLES THAT ARE AFFECTED BY CONSUMER PROTECTION MATTERS



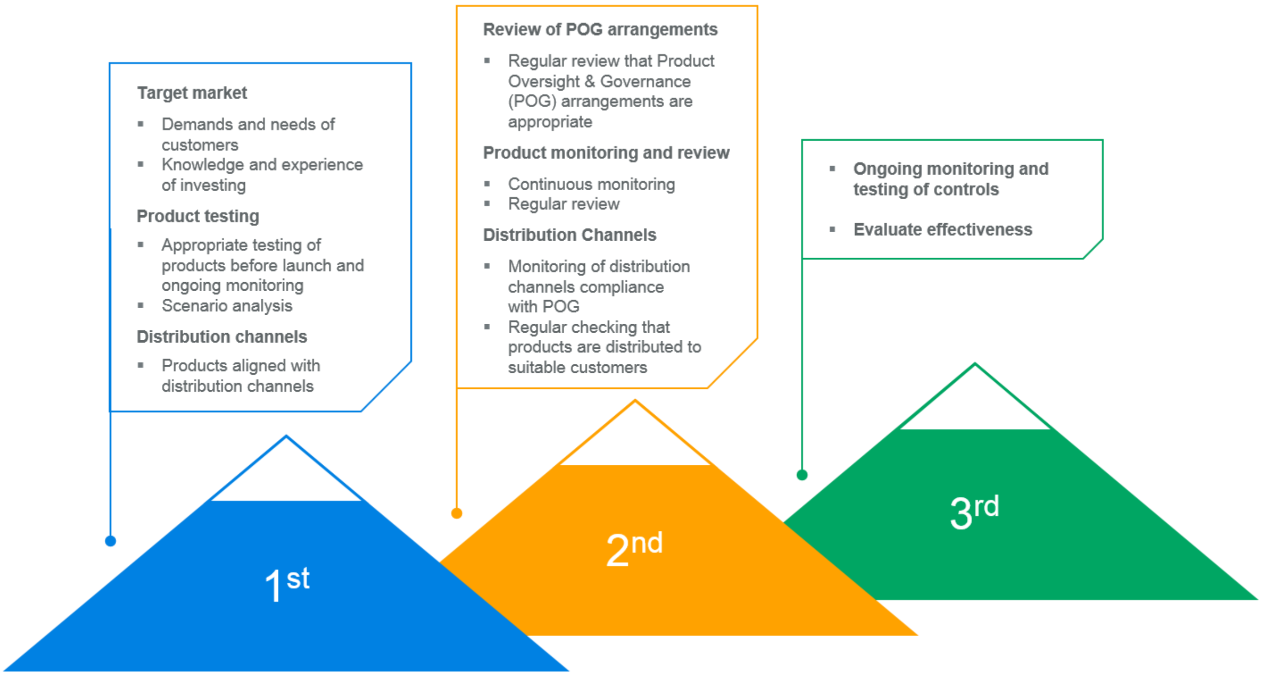
There is a challenge for firms in defining conduct risk. As a starting point it should be considered with a focus on the customer. It should not be confused with reputational or operational risk, which generally measure damage to the firm. A firm's conduct risk profile is unique. A "one-size fits all tick-box" compliance exercise is not sufficient. Firms need to articulate what conduct risk means to them individually and ensure that a consistent understanding flows through their organisations.

A more holistic view of conduct risk as the management of consumer protection issues has been emerging in recent years. To reflect this, regulators' definitions of conduct risk have been expanding. Good governance of product life cycles and a consumer-centric culture are seen as the bedrock of successful conduct risk management.

Documented governance frameworks need to clearly set out the roles and responsibilities of individuals with respect to conduct of business risks. Actions to be taken on breaching certain triggers should be clearly set out.

In the context of the commonly used 'three-lines-of-defence' model, management information will be collected by the first line while the overall effectiveness of conduct risk controls should be monitored by the second line (in this case, the risk function). Internal audit, acting as the third line of defence, should periodically review the conduct risk management arrangements, with an assessment being made as regards the level of challenge and analysis by the business and the risk function, with evidence of actions that have addressed conduct risk issues that have arisen.

FIGURE 2: CONDUCT RISK GOVERNANCE: THREE LINES OF DEFENCE



BOARD AND C-SUITE ROLE IN CONSUMER PROTECTION

The board of directors is ultimately responsible for the establishment, subsequent reviews and continued compliance of the conduct of business arrangements. The board should also ensure that the conduct of business arrangements are appropriately designed and implemented within the governing structures of a company.

The conduct of business arrangements, as well as any material changes to those arrangements, should be subject to prior approval by the board. Conduct risk management has a substantial link to the systems of governance of firms and should feed into the overall risk management framework of a firm. Conduct risk should also be within scope of firms' Own Risk and Solvency Assessments (ORSAs).

A firm's culture and governance structure lies at the heart of designing and implementing a suitable conduct risk management framework. Regulators increasingly want firms to be aware of the importance of establishing the right 'tone from the top', with firms' boards and senior management providing guidance and leadership regarding which values and behaviours are rewarded or discouraged.

We increasingly see boards and senior management prominently involved in supporting the status and visibility of long-term consumer protection risk initiatives, for example by organising video messages, poster campaigns and conduct events.

To encourage understanding and engagement of all staff, boards are setting clearly defined goals for these initiatives and are working to embed them into business as usual processes, risk management frameworks and strategic frameworks.

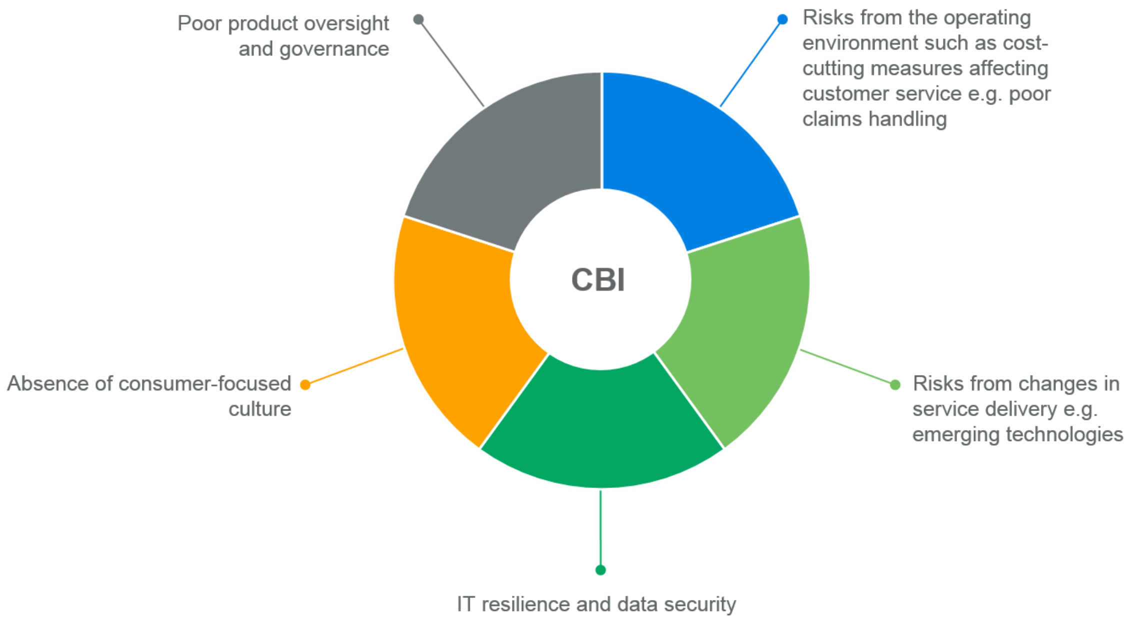
CONDUCT RISK DEVELOPMENTS AROUND THE GLOBE

Responding to past conduct of business failures, regulators globally have been developing the regulatory infrastructure around conduct risk. Specific emerging themes in the regulatory landscape addressing conduct risk include the following:

- Regulators splitting roles between conduct and prudential supervision, e.g., the UK and South Africa
- More conduct risk reporting requirements, e.g., South African Conduct of Business Returns (CBRs) introduced in 2017
- Customers' best interests being at the heart of the product life cycle, e.g., Insurance Distribution Directive in Europe coming into effect in 2018
- Looking at product outcomes from a customer's perspective
- Outcomes-based regulation, e.g., Treating Customers Fairly initiatives in the UK and South Africa
- Intensive and intrusive supervision, e.g., the Central Bank of Ireland's Consumer Protection Risk Assessment (CPRA) model in use from 2017
- Governance structures and active controls
- More explicit responsibilities for senior management and the board and individual accountability, e.g., the UK's Senior Managers and Certification Regime
- Financial impact of conduct risk events coming under focus

The Head of Consumer Protection at the Central Bank of Ireland set out that particular regulator's views on key conduct risk issues in a May 2016 speech, which are summarised in Figure 3.

FIGURE 3: 'A REGULATORY PERSPECTIVE ON CONSUMER RISK'



CONDUCT RISK MANAGEMENT IN PRACTICE

A suitable conduct risk management framework can be built around product life cycles. A generic presentation of a financial services product life cycle may look like the diagram shown in Figure 4.

FIGURE 4: PRODUCT LIFE CYCLE

Figure 5 sets out some key steps in developing a conduct risk management framework. The various elements of the product life cycle should be addressed in each step.

FIGURE 5: STEPS TO DEVELOP A CONDUCT RISK MANAGEMENT FRAMEWORK

1. Identify conduct risks
2. Develop a conduct risk appetite
3. Document management and mitigation of conduct risks
4. Ensure conduct risk awareness throughout the firm
5. Assign ownership and accountability for conduct risks
6. Monitor and track conduct risks

CONCLUSION

The UK's Financial Conduct Authority (FCA) encapsulated the expectations on firms in addressing conduct risk issues by calling for a move away from the following types of behaviours:

- Prioritising profits over ethics and commercial interests over consumer interests
- A tick-box approach to compliance
- The idea that disclosure at the point of sale absolves the seller from responsibility for ensuring a product or service represents a good outcome for the customer (note the erosion of caveat emptor)
- Complying with only the letter (rather than the spirit) of laws and regulations

We expect regulators will consider firms' approaches to such matters, and also whether the board is engaged with these issues. This is likely to represent a significant cultural shift for some firms, and accordingly it is important to ensure that this change in the regulatory environment is taken into account when designing a firm's conduct risk management framework.

Senior management are increasingly being held to account for conduct risk failings, and accordingly a strong conduct risk framework is an important tool in protecting against such failings.

Based on our experience of assisting clients in this area, conduct risk management is still evolving and firms face many challenges. There are a number of actions firms can take to achieve stronger conduct risk management, including:

- Review of conduct risk appetites
- Identification of conduct risk drivers
- Development of key risk indicators
- Improvement of processes for collection of suitable management information

There is no one-size-fits-all solution to conduct risk that will suit every organisation. Firms must develop their own conduct risk definition and strategies tailored to the specific risks that they are exposed to and the needs and culture of their organisations.

The key aim of conduct risk management is to ensure that firms do the right thing for their customers, whilst keeping them at the heart of everything that they do. Firms should seek to promote good behaviour across all aspects of their organisations and develop a culture in which it is clear that there is no room for misconduct.

A copy of the full report is available at the link below or you can request it from the authors:

Full report

Karl Murray
karl.murray@milliman.com

Eamonn Phelan
eamonn.phelan@milliman.com

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