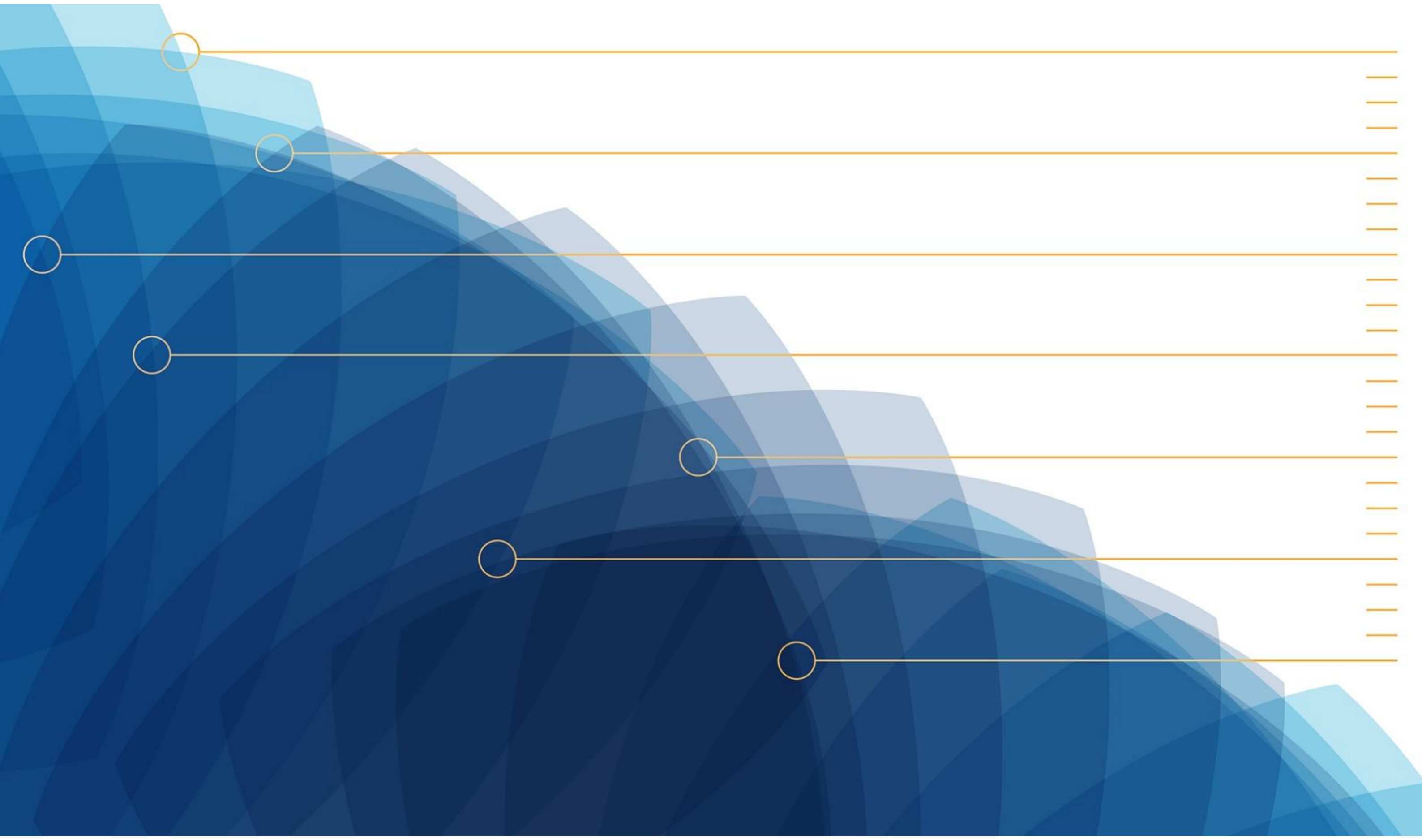
MILLIMAN RESEARCH REPORT

Global developments in conduct risk management

December 2017



Karl Murray, FSAI
Eamonn Phelan, FSAI

Milliman

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Authors and Acknowledgements

LEAD AUTHORS

Karl Murray, FSAI, is a Senior Consultant with the Dublin office of Milliman. Contact him at **karl.murray@milliman.com**.

Eamonn Phelan, FSAI, is a Principal and Consulting Actuary with the Dublin office of Milliman. Contact him at **eamonn.phelan@milliman.com**.

CONTRIBUTING AUTHORS

Australia: Craig McCulloch

Japan: Masaaki Yoshimura, Rikiya Ino

South Africa: Morne de Vos, Kim Oliver

UK: Emma Hutchinson, Fred Vosvenieks, Thomas Bulpitt

United States: Tim Hill

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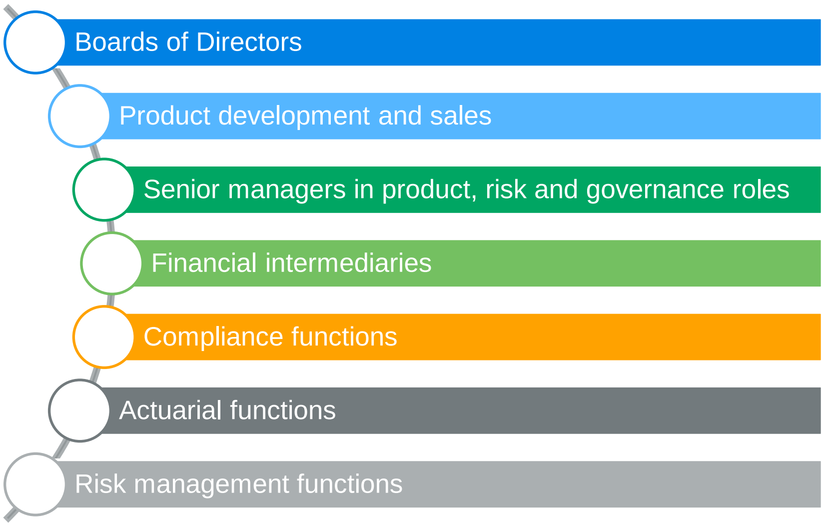
1. Executive summary

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. In turn, the corporate setting with regards to incentives and remuneration needs to support this activity.

FIGURE 1: ROLES THAT ARE AFFECTED BY CONSUMER PROTECTION MATTERS



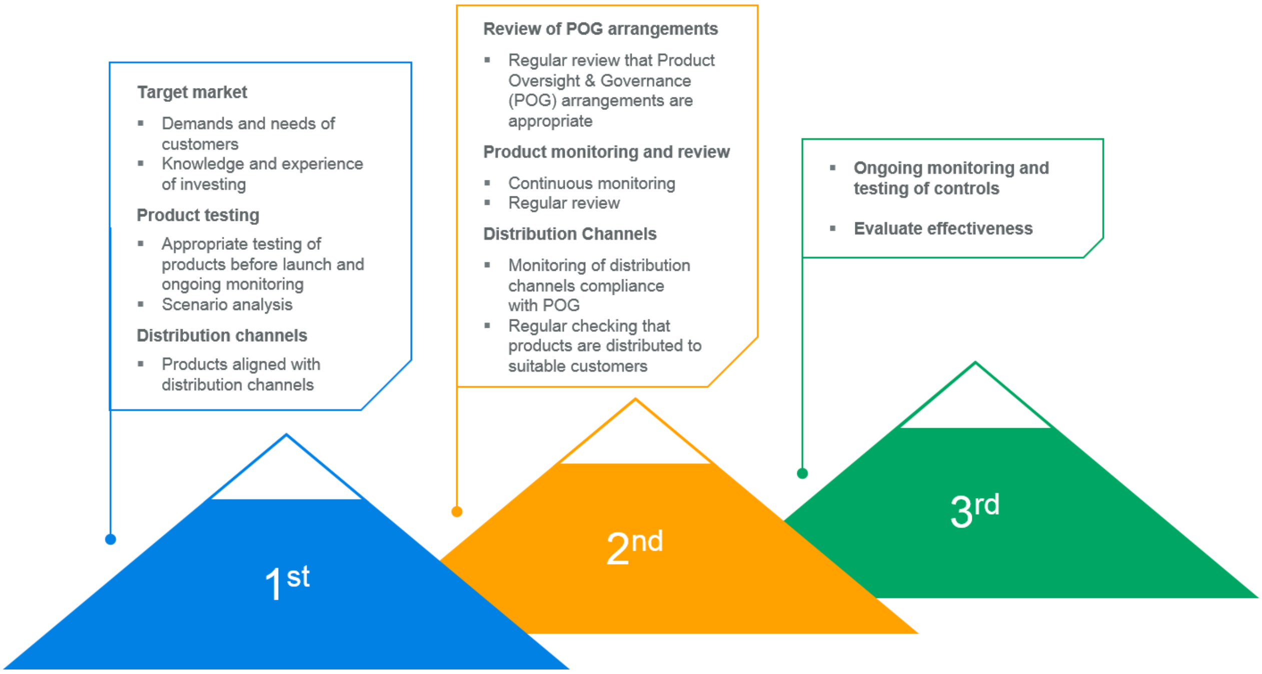
There is a challenge for firms in defining conduct risk. As a starting point it should be considered with a focus on the customer. It should not be confused with reputational or operational risk, which generally measure damage to the firm. A firm's conduct risk profile is unique. A "one-size fits all 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



1.1 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.

1.2 CONDUCT RISK DEVELOPMENTS AROUND THE GLOBE

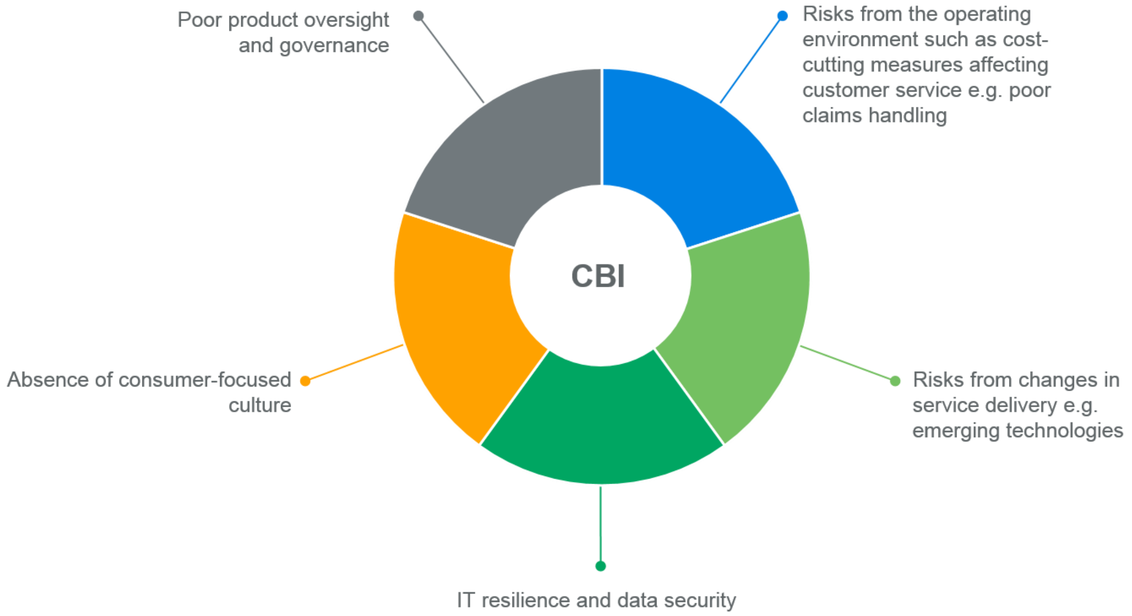
Responding to past conduct of business failures, regulators globally have been developing the regulatory infrastructure around conduct risk. Specific emerging themes in the regulatory landscape addressing conduct risk include the following:

- 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'



1.3 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

1.4 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.

2. Introduction

2.1 CONDUCT RISK

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.

2.2 OBJECTIVES OF THIS PAPER

This paper discusses actions firms need to take in order to the address the changing business and legislative environment with regards to consumer protection.

The research included in this paper covers the structural changes firms are making, or need to make, to reach maturity in their conduct risk management frameworks. Conduct risk should be considered to cover all stages of a product life cycle, including development, sales process and post-sales handling, as well as the overall governance and firm culture aspects.

The analysis in the paper is set in the context of past conduct failures across the financial industry, drawing lessons from those failures and setting out how they can be mitigated going forward through suitable risk management strategies.

We recognise that a jurisdiction's tradition, culture, operating environment and legal regime may impact on the regulatory approach to conduct of business, particularly in areas such as:

- The level of consumers' financial education
- The role of consumer protection associations
- The role of industry associations
- The role and accessibility of the court system

This paper is primarily focussed on jurisdictions where consumer support structures are already relatively advanced.

2.3 STRUCTURE OF THIS PAPER

This paper is structured as follows:

- Section 3 outlines the key role of boards and the C-Suite in consumer protection matters
- Section 4 surveys recent conduct risk legislative developments throughout the globe
- Section 5 covers practical aspects of conduct risk management

3. Board and C-Suite role in consumer protection

Regulators increasingly expect consumer protection matters to be a key focus of the board and C-Suite of financial services firms. For example, some of the high-level objectives of the board and C-Suite could include the following:

- Broadening the knowledge base within the firm regarding conduct risk requirements
- Kick-starting initiatives to address regulatory requirements relating to conduct risk
- Coordinating activities across the conduct risk management framework and ensuring conduct risk management is embedded within the firm

Key aspects in establishing and operating a suitable governance structure with regard to conduct risk will include:

- Defining roles and responsibilities
- Preparing Terms of Reference for relevant board and management committees
- Preparing a standing agenda for such meetings

Board-led activities may cover items such as the following:

- Setting the foundations for a suitably designed conduct risk management framework. For example, core elements may cover the following:
  - Identification of conduct risks, which will be specific to each firm
  - Articulation of the firm's conduct risk appetite
  - Documenting the governance, systems and controls in place to manage and mitigate conduct risks
  - Ensuring conduct risk awareness throughout the firm
  - Assigning clear ownership and accountability for conduct risks
  - Monitoring and tracking the risks using appropriate methodologies, metrics and management information
- Prompting conversations at the C-Suite level in terms of conduct risk around fairness, transparency, customers' best interests, etc.

Across the more day-to-day activities and ongoing oversight roles the following matters may be led by the likes of the Chief Risk Officer (CRO) and compliance areas:

- Identifying the controls that should be put in place to manage conduct risk, posing questions such as:
  - What are relevant elements of conduct risk policies and procedures?
  - What type of relevant management information should be collected?
  - How are bad behaviours avoided?
- Reporting of conduct risk, both internally and externally, to help assess the effectiveness of the conduct risk management framework:
  - Formation of suitable reporting of conduct risk issues
  - Designing an appropriate conduct risk event register

A firm's culture and governance structure lies at the heart of designing and implementing a suitable conduct risk management framework. We now discuss these items in more detail.

3.1 CULTURE AND GOVERNANCE

Culture is the product of a number of different drivers within a firm, and is shaped by many influences that drive the behaviour of everyone in an organisation. The 'tone from the top', incentive structures and the effectiveness of management and governance all contribute to the overall culture of a firm.

Boards have a critical role in setting the 'tone from the top'. Boards should take responsibility for their firm's cultures and key drivers, ensuring culture remains high on the agenda and that an appropriate culture is embedded throughout the firm at all levels.

Senior managers need to ensure that their firms' business processes, people and remuneration support and reinforce the culture the firm wants to embed. Senior managers have a crucial role in demonstrating that they are accountable and responsible for their parts in delivering effective governance. They should also be able to explain principles of appropriate conduct towards consumers and communicate it throughout the organisation.

Demonstration of a well-functioning culture includes taking steps to proactively identify and address issues when things go wrong and learning from these events.

The UK's Financial Conduct Authority (FCA), for example, has identified *'a clear link between poor culture and poor conduct',* with the potential for conduct risks to arise from:

- Weak leadership and governance
- Inappropriate business models and strategies
- Poor management information and decisions
- Lack of ownership and accountability
- Ineffective recruitment, training and/or incentive structures

3.1.1 Examples of culture improvements

We now describe some examples we have observed of steps taken by financial services firms to improve conduct culture.

Leadership
Financial services firms are 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 either rewarded or discouraged.

We increasingly see boards involved in supporting the status and visibility of long-term conduct risk initiatives, for example by organising video messages, poster campaigns and conduct events. To encourage understanding and engagement of all staff, boards are setting clearly defined goals for these initiatives and are working to embed them into business as usual processes, risk management frameworks and business strategy.

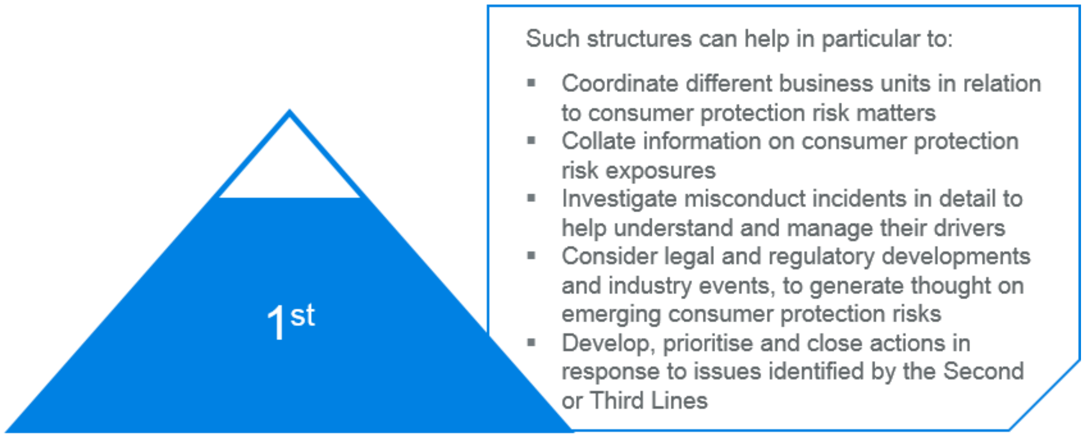
Governance
The typical 'three lines of defence' risk governance model involves these factors:

- Firms' boards retain ultimate responsibility for implementing the conduct risk management framework and policy
- Responsibility for the day-to-day management of conduct risk is embedded within the first line of defence
- Oversight, challenge and assurance of conduct risk management processes is provided by the second line
- Independent assurance of these processes is provided by the third line

We have observed for some firms that strict governance processes are adhered to at all stages of the product life cycle, with review, challenge and approval required for decisions and actions that affect consumer outcomes.

FIGURE 6: FIRST AND SECOND LINE ROLES

As part of the **First Line**, some larger firms have established a dedicated steering group to assist with managing consumer protection risks.



As part of the **Second Line**, some firms have also created specific risk committees to focus on conduct risk.

Strategies

Many firms set policies, principles, codes of conduct and service standards, which all employees must understand and comply with. Outcomes from these measures are regularly monitored to ensure that everyone is working towards the same goal.

We have seen examples of firms conducting employee surveys, to better understand their values and what influences their behaviours. Customer insights can also be utilised as a tool for management to understand consumer perceptions and measure customer outcomes and experiences.

Accountability

When poor business conduct emerges, firms are increasingly considering not just the individuals directly involved, but also the role of relevant control functions, senior managers, business unit managers and bystanders. Accountability within firms is becoming more widespread, with the onus on everyone to proactively act in the best interests of customers.

Staff training and incentives

Staff recruitment, training, promotion, performance management and remuneration are linked to conduct and culture objectives. Examples of successful approaches include:

- Training for small groups, perhaps targeted at specific business functions or levels of seniority
- Broadcasting lessons learned from past conduct incident case studies
- Gathering feedback on people's conduct and behaviour and communicating this to staff
- Rewarding excellent conduct by public acknowledgement or staff rewards
- Focussing the linkage between conduct and remuneration on senior management and those in risk-taking positions

3.2 REGULATORY PRESSURES ON BOARDS AND SENIOR MANAGEMENT

Some supervisors take a forward-looking approach to conduct of business risk 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. Such communications should provide a key point of focus for boards and senior management to direct their conduct risk activities.

For example, the UK's FCA publishes an annual Risk Outlook which is embedded within its published Business Plan. These publications set out the FCA's views on the conduct and prudential landscape for the firms it regulates. They look at the causes of risks and how they affect consumers, and use this to prioritise areas of supervisory focus in the future.

In its 2017/2018 Risk Outlook a central theme of the FCA is the delivery of financial services to an ever-ageing population and it notes some inherent risks, including:

- Older consumers are at increased risk of scams
- Quality of advice around retirement income, difficulties in comparing products and services and potential exclusion through increased use of digital services
- Consumers could face limited product availability and advice if firms fail to evolve to meet
- The changing needs of an ageing population—particularly those with lower prospects for wealth
- Accumulation—including pensions, insurance and other retirement income products.

The risk relating to increasing use of technology to deliver customer services is also a central theme in the FCA's Risk Outlook:

- High reliance on technology and the interconnectedness of markets at the European and global level mean that cyber attacks or system glitches may create widespread disruption.
- Increasing use of digital technology has become a barrier for some. Older people in particular are less likely to be computer literate.
- Technological developments have increased the sophistication of financial services—this presents both risks and opportunities for improving consumers' financial capabilities and financial inclusion.
- Where new technology is adopted at different speed within a business, this could lead to potential poor outcomes if new and old systems cannot interact, such as consumer-facing mobile apps, or if data are linked inappropriately.

The Central Bank of Ireland (CBI) publishes its assessment of the key current and emerging risks to consumers on an annual basis, expecting each regulated firm to consider and manage these risks and any other relevant risks in the context of its strategy and business model. The assessment also informs its own supervision priorities and work planning.

For example, the CBI's Consumer Protection Outlook Report 2017 lists the following main consumer protection risks to focus on:

- Absence of consumer-focussed culture
- Indebtedness and arrears
- Growth in new lending
- Risks created by the ongoing low interest rate environment
- Insurance and protection risks
- Risks from poor product design and marketing
- Fintech and innovation
- Cyber risks, data protection and information technology (IT) resilience
- Customer service

4. Conduct risk developments around the globe

In recent years well-publicised conduct of business failings have emerged within the financial services industry globally. Examples of general issues that have given rise to poor customer outcomes include conflicts of interest, commission incentives, poor sales advice, poor matching of products to the needs of target customers, complex products, keeping customers' needs post-sale regularly updated, etc. More specific examples include the mis-selling of subprime mortgages in the United States and mis-selling of payment protection insurance in the UK.

As far back as 2012 the Joint Committee of the European Supervisory Authorities (ESAs), which is a grouping of insurance, banking and asset management regulators, conducted a survey among national European regulators to gauge problems or failures in the area of product development and governance processes within financial firms. The survey revealed numerous instances in which product manufacturers had failed to have proper product oversight and governance arrangements in place. Some of the highlights from the survey included the following:

- In the securities sector, the UK reported that traditional investments had been volatile and often disappointing for investors, which prompted many to consider alternative investments. Some of these alternatives included unregulated collective investment schemes, which invested in assets that were not always traded in established markets, were therefore difficult to value, may have been highly illiquid and had risks to capital that were generally opaque.
- Denmark experienced cases of large-scale mis-selling to inexperienced and risk-averse retail investors of highly complex structured products. Belgium as well as Finland identified issues with the increasing complexity of products, such as structured products in Belgium or product wrapping in Finland, which prevented consumers from comparing features, prices and charges and, thus, from making well-informed investment decisions. Actions, such as the moratorium by the Financial Services and Markets Authority (FSMA) on particularly complex structured products, have been undertaken to address these issues.
- In Italy, during reviews in 2007 and 2008, it was noted that the global financial crisis led intermediaries to search for alternative sources of funding and to the issuance and distribution of complex products to retail investors. These products lacked a liquid secondary market, and a lack of transparency in charges and valuations posed serious threats to consumers. Actions were undertaken to prevent and address conflicts of interests, poor internal arrangements and distortive staff incentives, as well as to favour the designing and distribution of products to the best interests of investors.
- In the insurance sector, France experienced some difficulties in the marketing of complex underlying investments. Consequently, the French regulatory agency, the Prudential Supervision and Resolution Authority (ACP), adopted a recommendation to improve disclosure and transparency towards clients when they are sold such a product. The Netherlands experienced high costs and opaque cost structures for unit-linked insurance and pension products.
- The UK experienced large-scale mis-selling of payment protection insurance products by some of its largest banks. Many consumers were often required to pay via a single premium that was added to the loan; faced significant barriers to switching; were not eligible to claim; were unable, or unwilling, to search for alternative products; and/or were pressurised into buying the product. The resultant regulatory action led to a substantial compensation scheme.
- In the banking sector, Estonia and Spain experienced problems with: (a) the poor presentation of risks associated with structured products; (b) an excessive degree of complexity (e.g., of index-linked deposits) given the market segments to whom the products were sold; and (c) certain hedging products with the aim to protect borrowers on flexible rate mortgages.

Based on the results of many further studies, in recent years customers across many markets have been confronted with financial products that did not meet their expectations, notably because of flaws in the products and/or the advice and sales processes adopted.

4.1 REGULATORY FOCUS ON CONDUCT RISK

Responding to such past failings, key areas of concern that continue to be raised by regulators across conduct of business include:

- Persistent and pervasive market conduct challenges and practices
- Unfair treatment of customers
- Poor customer outcomes

The Chair of the Financial Stability Board (FSB) has stated: *'The scale of misconduct in some financial institutions has risen to a level that has the potential to create systemic risks. Fundamentally, it threatens to undermine trust in financial institutions and markets, thereby limiting some of the hard-won benefits of the initial reforms'.*

Specific emerging themes in the regulatory landscape addressing conduct risk include the following:

- Regulators splitting roles between conduct and prudential supervision (see 'Twin Peaks' below)
- More conduct risk reporting requirements
- Customers' best interests being at the heart of the product life cycle
- Looking at product outcomes from a customer's perspective
- Intensive and intrusive supervision
- Governance structures and active controls
- More explicit responsibilities for senior management and the board and individual accountability
- Financial impact of conduct risk events coming under focus

Fair treatment of customers is at the heart of many conduct risk regulatory frameworks and in particular with regard to the protection of vulnerable consumers such as those in financial distress or with poor access to financial services. Such 'treating customers fairly' initiatives have been the forerunner to more sophisticated consumer protection frameworks in many territories.

4.2 SPECIFIC REGULATORY DEVELOPMENTS

In this setting, consumer protection is becoming an increasing focus for financial regulators. Many are taking a more proactive approach to promoting consumer protection than may have been seen in the past. This is evidenced by the extent of legislative change, industry studies and one-on-one firm engagement.

Case Study: 'Treating Customers Fairly' Initiatives

The regulation of conduct of business remains a challenge, despite progress associated with increased supervision, predominantly through the introduction of Treating Customers Fairly (TCF) types of regimes in many territories.

For example, in December 2014 the South African National Treasury published the discussion paper entitled, 'Treating Customers Fairly in the Financial Sector: A Draft Market Conduct Policy Framework in South Africa' (the Market Conduct paper). TCF represents an outcomes-based regulatory approach that seeks to ensure that specific, clearly articulated fairness outcomes for financial services consumers are delivered by financial institutions. It forms a key component of the new mandate in the Twin Peaks model of the Financial Sector Conduct Authority (FSCA).

The introductory guidance to Principle 19 of the IAIS's Insurance Core Principles (ICP 19 – Conduct of Business) describes conduct of insurance business as 'primarily concerned with the fair treatment of customers'.

The UK's Financial Conduct Authority (FCA) was at the forefront of initiatives in 2006, when it published its paper 'Treating Customers Fairly – Towards Fair Outcomes for Consumers'. Building on this the FCA now requires that firms strive to achieve the following six consumer outcomes:

- **Outcome 1:** Consumers can be confident they are dealing with firms where the fair treatment of customers is central to the corporate culture.
- **Outcome 2:** Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.
- **Outcome 3:** Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.
- **Outcome 4:** Where consumers receive advice, the advice is suitable and takes account of their circumstances.
- **Outcome 5:** Consumers are provided with products that perform as firms have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect.
- **Outcome 6:** Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint.

FIGURE 7: SURVEY OF CONDUCT RISK LEGISLATIVE DEVELOPMENTS THROUGHOUT THE GLOBE

Global: IAIS

The International Association of Insurance Supervisors (IAIS) has developed Insurance Core Principles that should be applied by national supervisors. There are five main conduct requirements: suitability of persons, corporate governance, risk management, internal controls and conduct of business.

The Insurance Core Principles (ICPs) provide a globally accepted framework for the supervision of the insurance sector. The ICPs prescribe the essential elements that must be present in the national supervisory regime in order to promote a financially sound insurance sector and provide an adequate level of policyholder protection.

ICPs 5, 7, 8 and 19 feature elements of conduct.

- **ICP 5: Suitability of Persons**

  The supervisor requires board members, senior management, key persons in control functions and significant owners of an insurer to be, and remain, suitable to fulfil their respective roles.

- **ICP 7: Corporate Governance**

  The supervisor requires insurers to establish and implement a corporate governance framework which provides for sound and prudent management and oversight of the insurer's business and adequately recognises and protects the interests of policyholders.

- **ICP 8: Risk Management and Internal Controls**

  The supervisor requires an insurer to have, as part of its overall corporate governance framework, effective systems of risk management and internal controls, including effective functions for risk management, compliance, actuarial matters and internal audit.

- **ICP 19: Conduct of Business**

  The supervisor sets requirements for the conduct of the business of insurance to ensure 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.

Global: FSB

The Financial Stability Board (FSB) operates under the aegis of the leading European rich and developing nations, G-20, and is charged with developing and promulgating global financial services policies designed to minimise the likelihood of another financial crisis by improving the behaviour of, and risk management within, firms.

The FSB has published a number of reports on measures to reduce misconduct risk in financial services. This follows a work plan agreed to in May 2015 which proposed to examine, among other things, whether the reforms to incentives, for instance to risk governance and compensation structures, are having sufficient effect on reducing misconduct and whether additional measures are needed to strengthen disincentives to misconduct.

In a May 2017 report the FSB set out next steps in its work to consider the role governance frameworks have to play in reducing misconduct, including an international stocktaking of activities already underway in this area. The FSB stated the following five themes that are key in conduct risk management:

1. Clearly defined corporate strategy and risk appetite with relevant controls.
2. Appropriate expertise, stature, responsibility, independence, prudence, transparency and oversight on the part of board members and control functions.
3. Corporate culture.
4. Effective control environment.
5. Appropriate people management and incentives.

FIGURE 7: SURVEY OF CONDUCT RISK LEGISLATIVE DEVELOPMENTS THROUGHOUT THE GLOBE (CONTINUED)

Europe

At a European level, there has been a change towards the European Supervisory Authorities (ESAs) taking more responsibility for matters which have historically (and indeed, legally) been perceived as something to be determined by national regulators. The creation of the ESAs in the wake of the crisis and following a recommendation from the de Larosière report effectively set up Euro-regulators which were given the objective of consumer protection.

Upcoming European-wide regulations, aimed at harmonising the sales advice process and general product governance in the EU for retail insurance, banking and asset management products, will apply to a wide range of financial firms from 2018, including:

- Insurance Distribution Directive (IDD)
- Product Oversight and Governance (POG) requirements
- Packaged Retail and Insurance-based Investment Products (PRIIPs)
- Recast of Markets in Financial Instruments Directive (MIFID II)
- Product complexity and sales process requirements
- Proposals for PRIIPs following environmental or social objectives
- European Personal Pensions developments

UK

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

On 28 June 2017, the FCA published a report setting out the final findings of its Asset Management Market Study, which includes proposals to drive competitive pressure on asset managers, increase value for money for investors and improve the effectiveness of intermediaries. The FCA is considering whether to extend some of these proposals to insurance companies selling retail investment products. This initiative represents an expansion of the FCA’s insurance focus, which has up to now mainly been on conduct issues relating to protection and with-profits business.

On 26 July 2017, the FCA published a consultation paper outlining proposals to extend its Senior Managers and Certification Regime (SM&CR) to insurers. The aim of the SM&CR is to reduce harm to consumers and strengthen market integrity by making individuals more accountable for their conduct and competence. This is likely to be a driver of cultural change within firms. In the past the onus has largely been on the collective firm to ensure good conduct, and the move to individual accountability should force management to take conduct risk more seriously.

United States

At the top of recently published US regulatory concerns was the issue of whether a distributor’s product recommendations to their clients were being driven by compensation rather than the clients’ ‘best interests’. To address this concern, the US Department of Labor (DOL) Fiduciary Rule was created. In April 2016, the DOL came out with regulations broadening its definition of 'investment advice fiduciary' under the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code. These regulations expand the scope of who is considered a fiduciary to ERISA retirement plans and IRAs. Previously only Registered Investment Advisors (RIAs) and their representatives were considered to be fiduciaries for advisory and consulting services. RIAs are paid a fee based on an hourly basis or based on a percentage of a client’s holdings. The new fiduciary definition includes a broader set of financial professionals, including insurance agents, insurance brokers and insurance companies.

FIGURE 7: SURVEY OF CONDUCT RISK LEGISLATIVE DEVELOPMENTS THROUGHOUT THE GLOBE (CONTINUED)

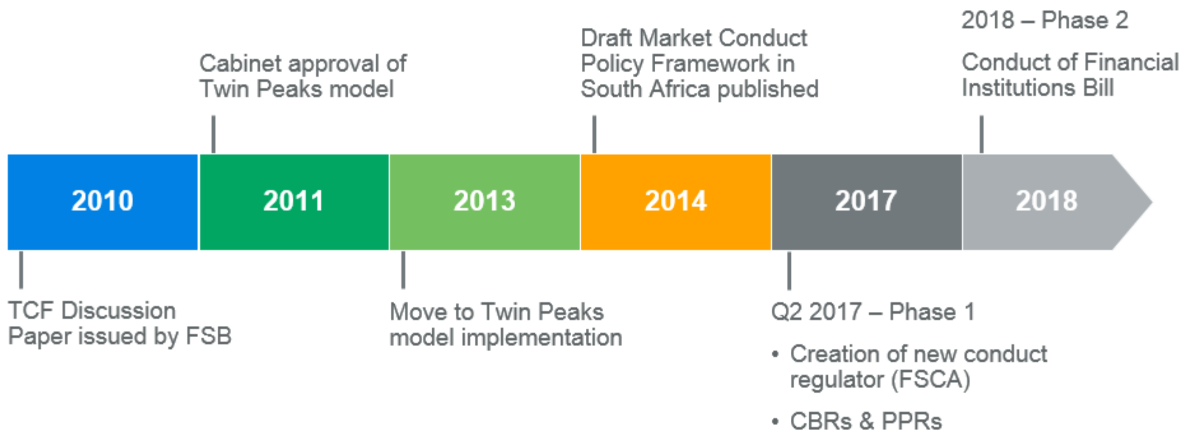
Specifically, the DOL made certain amendments to and partially revoked Prohibited Transaction Exemption (PTE) 84-24, which in the past has provided an exemption for a plan's payment of sales commissions to insurance agents, brokers and insurers in connection with a plan's purchase of insurance and annuity contracts and mutual fund shares. Advisors who sell variable annuities and indexed annuities will need to satisfy the conditions of the Best Interest Contract Exemption (BICE), which requires advisors who sell products to retirement clients on a commission basis to sign a contract with those clients disclosing potential conflicts of interest. The DOL Fiduciary Rule was partially implemented in June 2017, while full implementation has been delayed until January 2019. The expanded definition of fiduciary is currently in effect, along with new 'impartial conduct standards'. However, exemptions such as the BICE and any changes to PTE 84-24 have been delayed. It is possible that changes to the rule may occur before full implementation.

Other US regulatory bodies are following suit in redefining the definition of who is considered a fiduciary. The Certified Financial Planner (CFP) Board of Standards has recently proposed updating the Standards of Professional conduct governing all 77,000 CFPs. This proposal would require that CFPs act as fiduciaries on all financial advice given to clients. Also, the state of Nevada revised an existing law and now includes brokers and investment advisors under its fiduciary standard. As of July 2017, Nevada financial advisors must disclose any commission they receive based on guidance to clients and must make a 'diligent inquiry' about the client's financial condition and goals. Other states are considering similar requirements. In addition, the US Securities and Exchange Commission (SEC) is currently working on a Fiduciary Rule proposal in coordination with the DOL.

South Africa

Recent developments in the South African regulatory environment serve as a useful example of a maturing conduct risk regulatory environment.

The following diagram illustrates the evolution of Conduct Risk Regulation in South Africa:



The Financial Services Board (FSB) is an independent institution established by statute to oversee the South African Non-Banking Financial Services Industry 'in the public interest'.

In April 2010, the FSB published a discussion document entitled "Treating Customers Fairly" (TCF Discussion Document). The TCF Discussion Document indicated that an outcomes-based TCF regulatory approach would be adopted, to ensure that specific, clearly articulated fairness outcomes for financial services consumers are delivered by South African financial institutions.

The road map published by the FSB in March 2011, 'A Safer Financial Sector to Serve South Africa Better', confirmed its commitment to the TCF programme by setting out its approach to implementation.

A proposed shift to a Twin Peaks model was approved by Cabinet in July 2011. Essentially, the Twin Peaks model contemplates that the financial services sector will have two primary regulators, being a prudential regulator, the Prudential Authority (PA), and a new market conduct regulator, the Financial Sector Conduct Authority (FSCA), that will replace the Financial Services Board (FSB). The PA's objective will be to maintain and enhance the safety and soundness of financial institutions that provide financial products, whereas the FSCA will

FIGURE 7: SURVEY OF CONDUCT RISK LEGISLATIVE DEVELOPMENTS THROUGHOUT THE GLOBE (CONTINUED)

be responsible for the supervision of the conduct of business of all financial institutions, and the integrity of the financial markets.

In December 2014 the South African National Treasury published the discussion paper entitled, 'Treating Customers Fairly in the Financial Sector: A Draft Market Conduct Policy Framework in South Africa'. This paper expands and enhances the whole TCF approach. It is envisaged that the TCF outcomes will be adopted by the FSCA as its regulatory mandate blueprint, with the aim of entrenching the principles of fair treatment of financial customers.

The implementation of market conduct regulation across the financial sector is taking a two-phased approach:

Phase 1

- Existing primary legislation, namely the Short-term Insurance Act (STIA) and Long-term Insurance Act (LTIA), were amended via the Conduct of Business Returns (CBRs) and Policyholder Protection Rules (PPRs).
- Phase 1 includes legislation around complaints and claims handling as well as giving effect to binder regulations and certain proposals of the Retail Distribution Review (RDR).
- The Financial Sector Regulation Act 2017 (also referred to as the Twin Peaks bill) was signed into law by the President in August 2017. As noted above, the Twin Peaks model dictates that the financial services sector will have two primary regulators, the PA and the FSCA. The PA is expected to come into existence in the first half of 2018, and the FSCA at the earliest in the second half of 2018.

Phase 2

- Phase two of the implementation process will be focussed on revising, consolidating and harmonising the legal framework for prudential and market conduct in the financial sector.
- The market conduct paper essentially introduces this Phase 2 of the implementation process and provides information on the proposed approach to market conduct regulation in South Africa, explaining the policy framework within which the FSCA will operate.
- The Conduct of Financial Institutions (CoFI) Bill will replace existing sectoral legislation. The passing of the Twin Peaks bill paves the way for the Conduct of Financial Institutions Bill (COFI Bill) which will embed the supervisory responsibilities of the FSCA. Current indications are that the COFI Bill will be passed in 2019.

PPRs

As a preamble to the COFI Bill, a set of Policyholder Protection Rules (PPRs) have been published. They are intended to give effect to a number of conduct of business reforms, and extend on requirements previously introduced through the TCF principles.

The PPRs bring about increased responsibilities for senior management and the board, summarised as follows.

- Product line design

An insurer's managing executive must sign off on new product lines before they are marketed or offered.

- Claims management

Identified risks, trends and actions taken in response thereto and the effectiveness and outcomes of the claims management framework must be reported regularly to the executive management, the board and any relevant board committee.

The board of directors is responsible for effective claims management and must approve and oversee the implementation of the insurer's claims management framework.

- Complaints management

The board is responsible for effective complaints management and must approve and oversee the implementation of the insurer's complaints management framework.

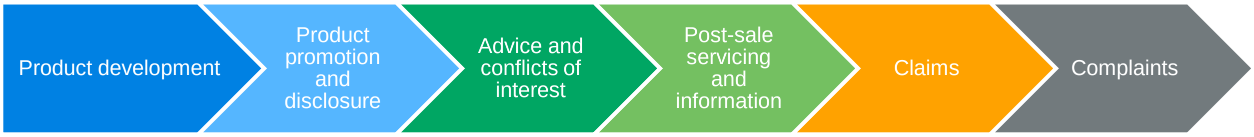
CBRs

The Conduct of Business Returns (CBRs) are a new set of returns that need to be completed by all life and non-life insurers, excluding reinsurers and captive insurers. They feed into the overall market conduct risk-based supervision framework, which contemplates the development of conduct risk profiles for individual insurers and groups.

5. Conduct risk management in practice

We now turn to practical aspects of conduct risk management, in particular focussing on the product life cycle and the conduct risk management framework built around that cycle. As a framework for considering the stages of the product life cycle, ICP 19 of the IAIS covers the headline topics shown in Figure 8 across the product life cycle, which are useful to bear in mind.

FIGURE 8: PRODUCT LIFE CYCLE



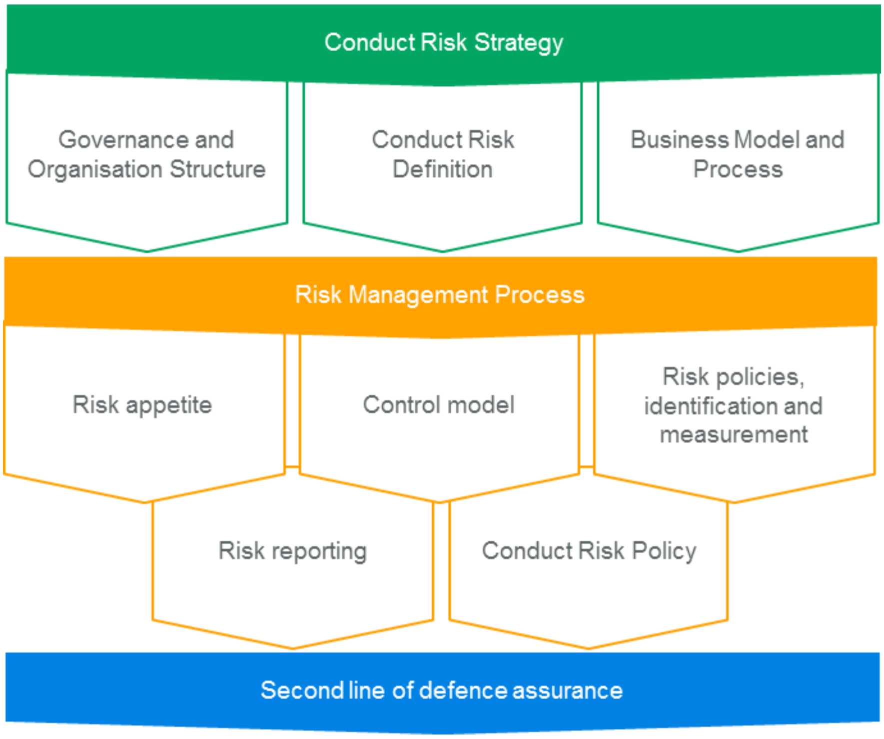
In this section we focus on the identification of risks across the product life cycle, with particular emphasis on overall product oversight and governance as well as conduct risk measurement and reporting. Firstly, we discuss the establishment of a suitable conduct risk management framework.

5.1 CONDUCT RISK MANAGEMENT FRAMEWORK

Conduct risk management has a vital link to firms' wider systems of governance and should feed into their overall risk management frameworks. A conduct risk management framework should be developed around the business model of the financial institution and in particular the product life cycle.

At a high level, key components of a conduct risk management framework could include those shown in Figure 9.

FIGURE 9: CONDUCT RISK MANAGEMENT FRAMEWORK



Establishing the right manner in dealing with conduct risk requires a consistent approach to address it. A clear conduct risk strategy is essential which specifies risk management directives, the governance, oversight and manner in which the 'tone at the top' is established by the board and senior management of the financial institution, with clear lines of responsibility and accountability for conduct risk established. Firms should ask themselves questions such as:

- 'What does good behaviour look like for our firm?'
- 'What do we need to communicate internally and externally on our tolerance to misconduct?'

As a starting point the definition of what conduct risk means for an organisation should be established. This effort sets the scope of the risk and therefore of the risk management framework itself. The conduct risk management framework is supported by an organisation structure and governance model that establishes clear responsibilities across the first and second lines of defence.

An organisation should define a conduct risk appetite. Conduct risk appetite statements are now used by many firms to express the types of conduct of business failures that must be avoided. These statements are usually set and communicated by firms' boards and reflect the business strategy and objectives. Whilst most firms wish to avoid or minimise conduct risks insofar as possible, they generally acknowledge that 'low' tolerance is more realistic than 'zero' tolerance, given the wide range and nature of conduct issues.

The concept of 'risk appetite' can be difficult to visualise as clearly firms wish to avoid all conduct risk failures whilst recognising that isolated human and operational errors can lead to instances which result in customer detriment. In the context of conduct of business it is more meaningful to express risk appetite in terms of good conduct of business behaviours. For example, if customer detriment occurs, policies could require that the specific issue should be rectified within a reasonable timeframe, root-cause analysis be performed to better understand the underlying reasons and appropriate remedial actions be taken.

We set out below how a risk appetite could be expressed for the advisory stage of the product life cycle, for example.

- A high level statement could be that 'sales of products and advice offered must be conducted in such a way that ensures good customer outcomes'
- A series of sub-statements could include:
  - 'Sales staff and advisors must be appropriately trained and qualified'
  - 'Sales must be made to the target market identified'
  - 'Customers must be given adequate and clear information at the point of sale'

Outcomes in comparison to these objectives should then be assessed using a set of risk metrics and indicators.

The appetite should be translated into specific risk policies that set constraints on the business model. The business model in turn needs to ensure that the risks taken in the pursuit of the commercial strategy are within the limits defined in the appetite. Furthermore, regulators will expect firms to be able to demonstrate how conduct risk matters are driving business strategy and decision making as well defining what successful conduct risk outcomes look like.

Defining a control framework for conduct risk is useful in ensuring alignment with internal policies. Different types of controls should be operated across the product life cycle.

The second line of defence should use a set of tools to provide assurance that the risks taken do not exceed the appetite defined. These tools include measuring the risk exposures and a framework for gathering and reporting management information.

Operationalising the conduct risk management framework can be performed only with the establishment of a conduct risk policy, which brings together the following items:

- The mandate from the board and strategic direction of the firm around managing risks of misconduct
- The governance framework and components of the conduct risk management framework that are required to be deployed across the three lines of defence
- The firm's conduct risk universe across the operating model

The policy also covers the kind of tools, metrics and processes required for enabling a consistent approach to address conduct risk throughout the operating model.

Management information should be reported at board level with senior management able to evidence how they use this information to drive the business.

Specific training and awareness-raising initiatives should be undertaken with a view to embedding conduct risk matters into existing process, procedures and practices. Employees should be incentivised and rewarded in a way that encourages the right outcomes. Furthermore, remuneration, recruitment, performance management and promotion policies may need to be reviewed to ensure that they are reinforcing the right values and embedding best practice behaviours.

Case Study: Central Bank of Ireland's Consumer Protection Risk Assessment Model

In March 2017, the Central Bank of Ireland (CBI) published its Consumer Protection Risk Assessment (CPRA) model. This new approach provides the CBI with a framework to assist in planning and carrying out assessments of how consumer risk is identified and managed within regulated firms.

The CBI requires all regulated firms to implement consumer protection risk management frameworks that take into account the nature, scale and complexity of the firm, as well as encompassing the risks the framework is intended to manage.

The CPRA model is comprised of five modules reflecting, in turn, the CBI's expectations of an appropriately structured consumer protection risk management framework. Each module contains a number of distinct submodules, called elements, each of which relates to a specific aspect of consumer protection risk which the CBI will assess:

- **Module 1: Governance and Controls:** The aim of this module is to evaluate the appropriateness of roles and responsibilities within the firm from the point of view of consumer protection. This unit will also consider the effectiveness of firms' risk management frameworks in respect of managing consumer protection risks.
- **Module 2: People and Culture:** The CBI will evaluate the degree to which firms have a consumer-focussed culture. The emphasis here will be on aspects such as firms' behaviours, recruitment, training and remuneration.
- **Module 3: Product Development:** This module considers the product development phase of the product life cycle. This includes an assessment of marketing collateral, distribution arrangements and product monitoring processes.
- **Module 4: Sales/Transaction Process:** The focus here will be on how firms distribute and sell their products and services. The aim of this module is to assess the fair treatment of consumers during the sales process.
- **Module 5: Post-Sales Handling:** Undertakings will be assessed on the appropriateness of their post-sales governance arrangements and processes.

The CBI has stated that there is no specific requirement for firms to design and develop a separate framework for consumer protection risk management. Instead, it is requesting firms to enhance existing risk management and internal control frameworks to incorporate and comply with the new standards.

The CBI has outlined a number of minimum practices which firms should consider in respect of developing and embedding their consumer protection risk management frameworks. In particular, firms should carry out the following activities:

- Identify consumer protection risks specific to the individual firm
- Articulate the firm's consumer protection risk appetite
- Document the governance, systems and controls in place to manage and mitigate consumer protection risks
- Ensure consumer protection risk awareness is embedded throughout the firm
- Assign clear ownership and accountability for consumer protection risks
- Use appropriate methodologies, metrics and management information to monitor and track consumer protection risks

Specifically, the CBI will seek evidence that undertakings have in place a suitable policy in respect of consumer protection, an active consumer protection committee, and have identified the person(s) responsible for consumer protection and conduct risk within the organisation. Undertakings will also need to demonstrate that board and management committees are aware of key consumer protection risks, that they are monitored effectively on an ongoing basis and that they are central to the decision-making process of the company.

Having discussed the wider view of a framework for appropriate conduct risk management we now turn to the general sources of conduct risk and suitable indicators that can be used to focus priorities.

5.2 ARTICULATION OF CONDUCT RISK AND RISK TAXONOMIES

Definitions of conduct risk vary amongst firms, but most refer to 'treating customers fairly' and the 'delivery of good consumer outcomes'. Some also refer to avoiding actions that are detrimental to consumers or cause reputational damage to firms. Having a firm-wide definition for conduct risk is good practice, as it is likely to promote consistency in how conduct risks are treated across the business.

The need to review risk management frameworks to address conduct 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 help in the determination of the sources of risk and whether the activity giving rise to the risk should be curtailed or ceased in its entirety, as well as dictate the type of risk mitigation measures applied.

For example, to the extent that conduct risk is 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 danger that customer interests are addressed at an operational level, without paying due regard to the impact that a product manufacturer's or distributor's broad strategic goals may have on customers. An exclusively operational focus on customer outcomes may result in an entity focussing its risk mitigation efforts on addressing issues of customer service efficiency and transactional processes, without necessarily addressing customer outcomes when setting strategy, or designing products and distribution models.

Conduct risk may also be viewed under the heading of 'reputational' risk. This is understandable, as poor customer experience can clearly impact negatively on a product manufacturer's or distributor's image in the marketplace. 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.

Another relatively common classification of conduct related risk is to regard them as 'legal' or 'regulatory' risks. This is because regulatory frameworks typically impose specific consumer protection obligations on product manufacturers and distributors, with contraventions of them triggering potential supervisory action or sanctions. Where conduct of business risk is 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.

So in essence specific conduct risks may exhibit a mix of characteristics spanning the likes of operational, strategic, reputational, legal or regulatory risk that should all be considered.

5.3 SOURCES OF CONDUCT RISK AND RISK IDENTIFICATION

The sources and indicators of conduct of business risk may differ from those monitored by regulators focussing on prudential risk. As suggested by the IAIS, 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 (e.g., 'financial products are sold more than bought'), 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 product manufacturer's or distributor's own governance models or business processes can contribute to conduct of business risk, e.g., too heavy a focus on solvency risks, conflicts of interest in sales structures and corporate structures, inappropriately targeted product design, underwriting practices, non-advised sales, quality of advice, claims management and outsourced processes.
- **Economic and environmental factors:** These are factors related to the external environment in which a product manufacturer or distributor conducts its business, but which are typically outside its control, including risks introduced through either strong competition (e.g., promotion of add-on or bundled products or features that may not be necessary to the customer or may introduce hidden cost) or a lack of competition; or in a saturated market, there may be an increased tendency to target new markets such as unsophisticated, previously excluded consumers, where care must be taken to ensure that products meet a customer need.

Conduct risk management should use a balance of qualitative and quantitative indicators. Building on the groupings above, in identifying and monitoring conduct of business risk the IAIS for example has set out a set of conduct of business risk indicators as follows.

FIGURE 10: CONDUCT RISK INDICATORS

INDICATORS OF INHERENT RISKS	INDICATORS OF RISKS ARISING FROM GOVERNANCE AND BUSINESS PROCESSES	INDICATORS OF RISKS ARISING FROM ECONOMIC AND ENVIRONMENTAL FACTORS
▪ Vulnerability of customer base ▪ Complexity of products, including degree of risk transfer ▪ Type of distribution model ▪ Use of 'big data' ▪ Quality of initial and ongoing disclosure	▪ Extent to which customer interests are reflected in strategy and objectives ▪ Extent of alignment between customer interests and remuneration/incentives/performance management of staff and management ▪ Levels of staff training on conduct of business issues ▪ Quality of conflict of interest management ▪ Quality of controls in outsourcing arrangements ▪ Product design/selection processes ▪ Use of 'bundled' or add-on products ▪ Intermediary remuneration/incentivisation model ▪ Advice quality controls ▪ Data on lapses, surrenders, policy replacements ('churning') and other contract changes ▪ Underwriting approach ▪ Claims data and processes ▪ Complaints data and processes	▪ Levels of consumer indebtedness in target market ▪ Extent of customer exposure to market performance ▪ Extent of involvement in high-risk market-wide practices

5.4 CONTROLS AND EFFECTIVENESS

Having designed a suitable conduct risk management framework, a key aspect of a fit-for-purpose framework is the set of controls in place, as well as the operational effectiveness of such controls. Important controls include:

- Policies and procedures, including human resources (HR) policies such as recruitment, induction, performance management and reward
- Meetings
- Systems
- Board of directors
- Second line of defence, e.g., CRO and internal control
- Third line of defence, e.g., internal audit
- Frontline teams such as product development, marketing and sales and claims handling

More specifically, evidence of controls may extend to demonstrating the presence of the following:

- A set of consumer protection policies (e.g., management of complaints policy) and relevant operational procedures
- A Consumer Protection Committee or clear allocation of consumer protection responsibility embedded within another governance forum
- Appointment of a Head of Consumer Protection/Conduct or clear allocation of responsibility and accountability within other roles.

Once a firm has designed adequate controls to manage and mitigate consumer protection risks, it is equally important that the firm ensures the controls are being applied in the way they were intended to and are operating effectively in practice. Effectiveness of controls can be monitored in many ways, including:

- Regular monitoring of relevant management information (MI), such as key risk indicators or key performance indicators, specifically related to consumer protection risks and issues (see below)
- Ongoing monitoring of consumer outcomes
- Ongoing monitoring and testing of controls independently by the third line of defence (internal audit) and/or the second line of defence (compliance and risk management functions).

Although the UK's FCA has stated that the activities shown in the table in Figure 11 are recognised as effective in managing conduct risk of wholesale banks, the list provides a useful blueprint for other financial services firms to consider in their conduct risk programmes.

FIGURE 11: EFFECTIVE TECHNIQUES FOR MANAGING CONDUCT RISK, WHOLESALE BANKS

POSITIVE ACTIVITIES	NEGATIVE ACTIVITIES
▪ Highly visible CEO sponsorship together with engagement and challenge by the board ▪ Senior executives taking leading roles in programme design ▪ Programmes that cover front office, control and operational functions ▪ Detailed roll-out plans with clearly defined short-term and long-term goals ▪ Clear ownership and responsibility for programme implementation by senior executives, sometimes supported by conduct specialists within the organisation ▪ Programmes integrated within strategic or operational risk management frameworks ▪ Use of a standardised conduct risk self-assessment process across the firm ▪ A firm-wide taxonomy for conduct risk types, enabling consistent data capture and risk reporting ▪ A forum to compare conduct risk across business lines and functions ▪ Regular discussion at board level of conduct, culture and programme implementation ▪ Active engagement in the programme by internal audit, including monitoring the programme's early stage effectiveness ▪ Training, promotion, performance management and remuneration all linked to conduct and culture objectives ▪ Long-term conduct risk initiatives becoming fully embedded in business as usual	▪ One-off or stand-alone projects with a short timeframe ▪ Making Compliance or Chief Operating Officers (COOs) the primary driver of the programme ▪ Top-down mapping of desired conduct outcomes to business-level risks that were not balanced by similar bottom-up efforts by business units to identify where conduct risks could arise ▪ Disjointed or uncoordinated efforts by different business units ▪ Significant business units or control or operational functions being excluded ▪ Not examining whether conduct risk arising in one area could arise in another ▪ Programme focus being limited to front office senior personnel, with limited or no involvement from middle and back office, risk, control and other support functions

We now discuss in more detail the components of a conduct risk management framework covering general product oversight and governance arrangements, the sales process and post-sales handling.

5.5 PRODUCT OVERSIGHT AND GOVERNANCE

A key aspect of frontline business management is product design. Well-functioning product design involves understanding the needs of particular customer groups, working through what a fair outcome means for a particular product, stress testing how the product performs in different scenarios and whether it constitutes good value to the customer.

In Europe, the Joint Committee of the European Supervisory Authorities (ESAs) was tasked with developing a set of high-level, cross-sector principles on financial institutions' internal product approval processes. The aim was to enhance consumer protection by strengthening the process controls by manufacturers before product launch and thus discouraging products and services that may cause consumer detriment from reaching the market.

The term 'Product Oversight and Governance' (POG) was defined by the ESAs 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'.

In 2013 the ESAs developed the eight principles shown in Figure 12, which they agreed to consider when developing policy with regard to manufacturers' POG processes within the respective legal frameworks for banking, insurance and asset management.

FIGURE 12: PRODUCT OVERSIGHT AND GOVERNANCE PRINCIPLES OF THE ESAS

1. In order to minimise potential consumer detriment, avoid potential conflicts of interest, and ensure that the interests and objectives of target markets are duly taken into account, the manufacturer should establish, implement, and review on an ongoing basis product oversight and governance processes.
2. The manufacturer's executive board should endorse the product oversight and governance processes. Senior management should take responsibility for compliance with these processes before and after the launch of a product, and should ensure that adequate records of this assessment are maintained.
3. As part of the application of its product oversight and governance processes, the manufacturer should identify the target market of the product; analyse its characteristics; and ensure that the product meets the identified objectives and interests of that target market.
4. The manufacturer should conduct product testing to assess how the product would function in different, likely scenarios, including stressed scenarios, to ensure that the product is aligned with the interests and objectives of, and leads to fair outcomes for the target market.
5. When setting the charges and features of the product, the manufacturer should also take appropriate steps to ensure they are transparent for the target market.
6. The manufacturer should select distribution channels that are appropriate for the target market and disclose clear, accurate and up-to-date information to distributors.
7. The manufacturer should monitor periodically the functioning and operation of the product to ensure that it continues to meet the objectives and interests of the target market and should, where appropriate, review the product to ensure compliance.
8. The manufacturer should take appropriate action when issues that may lead to consumer detriment have materialised or can be reasonably anticipated.

These principles have served as important factors in the development of POG requirements in MIFID II and the IDD in Europe.

The UK's Tax Incentivised Savings Association (TISA) has also produced a 'Good Practice Guide for Product Distributors and Product Manufacturers'. Amongst the issues discussed are the following matters:

- Procedures and arrangements to ensure that conflicts of interest are properly managed
- Governance processes to ensure effective control over the manufacturing process
- The assessment of products' potential target markets
- The assessment of the risks posed of poor customer outcomes

- Due consideration of products' charging structures
- The provision of adequate information to distributors and the regular review of products

The general principles set out in the TISA's guidance are as follows (set in the context of asset managers under MIFID II but equally relevant for insurance and banking products):

- Firms must act honestly, fairly and professionally in accordance with the best interests of their clients
- The obligations for information to be fair, clear and not misleading applies to any relationship with clients
- The product governance process should be auditable and transparent
- The level of granularity of the target market and the criteria used to define the target market and determine the appropriate distribution strategy should be relevant for the product and should make it possible to assess which clients fall within the target market
- Investment firms should comply with the relevant requirements in a way that is appropriate and proportionate
- Where the MIFID II directive requires information to be provided in 'good time' to clients or potential clients, firms should take into account, having regard to the urgency of the situation, the client's (or potential client's) need for sufficient time to read and understand the information before making investment decisions.

5.6 GOOD PRACTICE EXAMPLES IN PRODUCT GOVERNANCE

In this section we discuss general good practice approaches to product governance.

Financial institutions that manufacture products should firstly establish and implement product governance guidelines setting internal arrangements for the design, marketing and life-cycle maintenance of products. These arrangements should ensure that products are designed to meet the interests, objectives and characteristics of a certain type of consumer (the target market). The arrangements should also identify any need to modify or replace existing products when they no longer meet the interests, characteristics and objectives of the target market for which the product was designed.

In Japan, on 30 March 2017, the Financial Services Agency (JFSA) released the 'Principles Concerning the Operation of Fiduciary Duty' to guide financial institutions toward customer-oriented business operation, and disclosed a list of financial institutions that adopted such principles, with some good practices on their website. The seven principles require financial services firms to:

1. Develop and disclose policies regarding customer-oriented business operations
2. Pursue the best interests of their clients
3. Manage conflicts of interest appropriately
4. Clearly communicate details regarding their charges for services
5. Disclose important information in a comprehensible manner
6. Provide services appropriate for their clients
7. Establish an organisational structure that motivates employees appropriately

Adherence to the principles is not mandatory, however, and firms will not be punished for noncompliance with them.

Globally we expect greater scrutiny of product governance by regulators—how a product is designed to go to market, how it will operate and the means of distribution. Regulators will consider whether a product has been designed around a target customer's needs; whether there is monitoring of customer outcomes; and whether information reaches the board or those who can address issues promptly. Distribution strategies will be subject to review to ensure that they are appropriate for the product.

In particular, firms will be expected to have procedures in place to assess their target markets. Products should be stress-tested and potential risks for consumers identified before a product reaches the market.

What is evident following various mis-selling scandals is that products are often sold to customers outside their target markets. What might be a perfectly sound product for one market may be utterly inappropriate for another. Firms will be expected to identify accurately who will benefit from different products and, perhaps more importantly, who should not be sold a particular product.

Examples of 'Best in Class' Approaches

The European Banking Authority (EBA) has identified several good practice approaches and they are listed in this section after the relevant requirement. The examples are also very relevant for nonbanking financial products.

The EBA states *'that good practice examples relate to the conduct of manufacturers' and distributors' tasks towards particular product oversight and governance arrangements that, if applied, will enhance consumer protection and will, as such, also contribute to ensuring the effectiveness of the financial system more generally. (The following) approaches are considered as good examples and are aimed at promoting common practices amongst financial institutions'.*

Good practice examples for manufacturers

Establishment, proportionality, review and documentation

A limit for regular review and update could be established, and/or factors that are relevant to the regularity of the review should be identified, e.g., significant changes in retail strategy, complexity of the product lines, complexity of distribution methods and distribution chain.

Target market
Manufacturers could consider one or more of the following:

- Tax status implications for different products
- Level of risks of the product to be designed
- Liquidity accessibility that the consumer is expected to get
- Level of risks that the consumer is willing to bear
- Demographic factors
- Level of knowledge and understanding of the complexity of the product
- Potential creditworthiness of the consumer or financial capability of the consumer

Product testing
In the case of a loan with a variable interest rate, the assessment could include the borrower's repayment requirements at reasonably higher interest rates.

Disclosure
In the case of a deposit, this could include, but is not limited to, the accessibility, yield and security of the funds, as well as any guarantee scheme that may apply.

Product monitoring
The manufacturer could only make changes to product features such as charges, interest rates and applicability of protection schemes that are consistent with the interests, objectives and characteristics of the target market.

Remedial action
A remedial action could be taken when the product no longer meets the general needs of the target market or when the product performance significantly differs from what the manufacturer originally expected and in a way that causes consumer detriment.

Distribution channels
In the case of mortgages or consumer credit, the manufacturer could monitor the sales volumes across various risk characteristics, such as loan-to-income ratios and loan-to-value ratios; and, where possible, a comparison could be made of such characteristics between its own staff and external distribution channels.

5.7 SALES PROCESS

A distinction can be made between general product governance arrangements, as discussed in the previous section, and individual transactional interactions with customers. In particular, at an individual level, distributors engage in either assessing general appropriateness of products for customers or specific personalised advice and suitability assessments (excluding 'execution-only' arrangements), as well as ongoing post-sale reporting to customers.

MIFID II and IDD raise the bar in Europe as regards the sales process engagement with customers. For example, firms are expected to have robust procedures to assess their target markets and to sell products to appropriate customers.

Sales processes should include provisions for records of sales to be maintained and be readily recoverable. Robust record retention is critical in the context of potential mis-selling in order to demonstrate that the right product was sold in the right way to the right customer at a particular point in time.

We have also seen heightened activity in other territories such as Australia.

Case Study: Australian Financial Advice Environment

In Australia, consumer risk issues associated with the provision of financial services have been under intense scrutiny for a number of years. Allegations around unfair treatment of life insurance claimants, inappropriate financial advice and questionable sales incentives have been common. A range of mis-selling remediation programmes, high-profile government inquiries and adverse media coverage have subsequently ensued, and the industry continues to grapple with the consequences.

Consumer protections
In broad terms, consumers are afforded protection in Australia from unfair contract terms, and have a range of statutory protections against the provision of goods and services which are not suitable for their stated purposes.

However, financial services contracts—notably insurance contracts and managed investment schemes (the main vehicle for unit-linked contracts in Australia)—are specifically exempted from these requirements. Specific requirements also exist for providers selling consumer credit contracts (i.e., loans and mortgages).

Consumer protections in the financial services industry are instead separately allowed for under a range of legislation and regulation. Of note are the following areas.

Financial advice and distribution of financial services products
Distribution of financial services products is governed by financial advice rules and regulatory guidance, covering both conduct and advice-related disclosures.

In particular, two forms of advice are considered: *personal advice*, and *general advice*. Personal advice is defined as any advice where the personal objectives, needs or circumstances of an individual are being taken into—or should reasonably be taken into—account. General advice may also involve a product sale, but is restricted to only providing factual information about the product.

The requirements for providing personal advice are largely principle-based. For example, advisors should:

- Provide advice which is appropriate to the customer
- Act in a client's best interests
- Prioritise a client's interests in the event of a conflict
- Make suitable inquiries about a customer's personal circumstances

Commissions on investment products
Following a range of high-profile financial advice 'scandals', a range of rules regarding the provision of financial advice—referred to as 'Future of Financial Advice' (FOFA)—were introduced in 2013. These aim to remove commissions on wealth management products. In effect, investment products can no longer have any form of 'conflicted remuneration'—any benefit which could reasonably be expected to influence the choice of product or advice given. This includes:

- Banning licensed advisors from receiving conflicted remuneration
- Banning product providers from paying conflicted remuneration
- Banning employers from paying conflicted remuneration to their employees providing advice

The effect of these rules is to ban all forms of commission payable on investment products, including:

- Initial and ongoing or percentage-based trail commissions
- Payments related to the volume of business written

- 'Shelf-space' fees payable by a product provider to an administration platform operator for making their products available on a platform, based on the volume of business placed on the platform
- 'Soft-dollar', i.e., non-monetary, payments

Advisors are, however, still permitted to agree with their customers to have fees deducted from customer accounts.

The resulting distribution landscape has changed considerably. Many financial advice firms now operate on 'fee-for-service' models. Further, the interpretation of many of these rules (such as the best interests duty), have seen low conversion rates of provider-owned distribution flowing to internally manufactured products. The vertically integrated models of larger providers have come under pressure, resulting in the sale of product manufacturing arms from parent entities owning multiple manufacturing, administration and distribution elements within the value chain.

Life insurance

Individual life Insurance contracts in Australia were specifically excluded from the FOFA rules, and have continued to pay commissions. Commissions payable on group life insurance (typically provided via a superannuation or pension fund) are not allowed.

The vast majority of life insurance business written in Australia is unbundled, annually renewable stepped premium risk policies—term life, disability lump sum, income protection and critical illness. Traditionally, initial commissions on such policies have exceeded 100% of first years' premiums, with additional renewal commissions payable.

In recent years, the industry has grappled with a range of issues that have been linked to high commissions—poor persistence experience, several high-profile mis-selling scandals, issues associated with outdated medical definitions used in declined claims and a general perceived lack of trust in the industry.

As a result of these issues, new government legislation is being introduced from January 2018 which will phase down maximum up-front commissions to 60% of first year's premiums, and cap ongoing commissions to 20% of premiums. Specific requirements for clawback provisions will also be introduced.

ASIC retail life insurance review

In 2014, the Australian Securities and Investment Commission (ASIC) published a report (REP-413) on the provision of retail life insurance advice. The report detailed the findings of an exercise which reviewed a sample of 202 policy sales files from prominent life insurance advisors.

The report found that 37% of cases reviewed failed to meet the legal standards set for providing advice. These cases were considered to represent serious failings of the law, ranging from compliance and documentation breaches to inappropriate or a lack of financial advice provided.

Notably, ASIC also found that there was a statistically significant link between up-front commission structures and advice failures. Where advisors were remunerated by up-front commissions, the failure rate was 45%. Where other commission structures were used, the rate dropped to 7%.

The impact of this report and related issues has been wide-ranging. The life insurance industry commissioned a review into commission structures, and has recently developed a new mandatory code of practice for life insurance providers.

5.8 POST-SALES HANDLING

Beyond the point of sale, the provision of clear and easily understood information throughout the product life cycle is crucial to ensure consumers are treated fairly. If customers seek information at any time, firms must deal with all such requests in a timely and efficient manner. Systems and controls should be in place that ensure the provision of information at all times in accordance with commitments made.

Where a firm offers products under which consumers will be entitled to make claims, it must ensure that their claims processes and procedures safeguard the fair treatment of customers throughout.

Good consumer outcomes are more likely to be achieved where customers can compare products effectively and where customers do not face unreasonable post-sale barriers to change product or switch provider.

Unreasonable barriers to switching might include the following deterrent factors which firms should look out for:

- High or disproportionate penalties for switching or closing accounts or products
- Excessive complication and administration for customers before they are able to switch or close
- Unreasonable risk to customers arising from potential exposure during the switching or closure processes
- Long initial exclusion periods (during which a claim cannot be made) or extensive exclusions

Effective complaints management is fundamental to conduct risk. Firms should demonstrate a culture which does not view complaints negatively. Root-cause analysis is an important factor in complaints handling. Firms should ensure that they have in place robust and proportionate systems and controls.

FIGURE 13: COMPLAINTS HANDLING AND ROOT-CAUSE ANALYSIS

STEPS IN EFFECTIVE COMPLAINTS HANDLING	STEPS IN EFFECTIVE ROOT-CAUSE ANALYSIS
▪ Make it easier for customers to complain and express their dissatisfaction ▪ Improve the investigation and prompt and appropriate decision making about complaints ▪ Communicate clearly with complainants ▪ Generate meaningful and granular management information and use this to guide decisions ▪ Identify and tackle the root causes of complaints to prevent similar problems reoccurring	▪ The collection of management information on the causes of complaints and the products and services to which complaints relate ▪ A process for analysing the causes of individual complaints so as to identify root causes common to types of complaint ▪ A process to prioritise dealing with the root causes of complaints ▪ A process to consider whether the root causes identified may affect other processes or products ▪ A process for deciding whether root causes discovered should be corrected and how this should be done ▪ Regular reporting to the senior management where information on recurring or systemic problems may be needed for them to play their part in identifying, measuring, managing and controlling risks of regulatory concern ▪ Maintenance of records of analysis and decisions taken by senior personnel in response to management information on the root causes of complaints

5.9 CONDUCT RISK MEASUREMENT AND REPORTING

The product life cycle and conduct risk management is not complete until suitable measurement of conduct risks is carried out and feedback used in the overall systems of governance of a firm. This is paramount in ensuring the effectiveness of the conduct risk management framework.

For the purposes of this paper we have not set out a systematic approach to conduct risk management information (MI) collection, but we believe that the procedures involving the collection of this MI should reflect the following typical characteristics of conduct risk drivers, for example:

- The aggregation of many events
- High impact/low probability events
- Low impact/high probability events
- The time lag between misconduct and detriment emerging
- The scale of detriment can depend on other factors, e.g., market movements
- The impact of the same monetary loss varies for different consumers

Useful MI should provide a current and forward view on conduct risks with tolerances established based on materiality. The MI should be meaningful and actionable. A challenge is making sense of the volume of data that can be generated.

We also expect to see significantly enhanced regulatory reporting requirements relating to conduct of business issues, certainly as evidenced for insurers under ICP 19 of the IAIS. This may pose a large operational burden on many firms, particularly for smaller organisations with limited granularity built into existing data structures.

Reported items may include the following, for example:

- Rate of growth relative to market
- The size, structure and product mix, including complexity
- Distribution models
- Types of customers
- Types of customer complaints
- Underlying trends, e.g., lapse, cancellations
- Specific data elements such as claims, premiums, policies in force, new policies written, non-renewals and cancellations, etc.

We also expect that conduct of business risk indicators will comprise a relatively greater proportion of qualitative information than prudential risk indicators.

We have seen a number of jurisdictions imposing conduct risk regulatory reporting requirements on firms. We now set out the approach being followed in South Africa as an example.

Case Study: South African Conduct of Business Returns (CBRs)

The CBRs are a new set of market conduct returns that will need to be completed by all life and non-life insurers in South Africa, excluding reinsurers and captive insurers. They will feed into the overall market conduct risk-based supervision framework, which contemplates the development of conduct risk profiles for individual insurers and groups.

Sections of the CBRs include:

- Business composition: Trends in sales, including details on mis-selling, lapses and cancellations per distribution channel.
- Distribution and binder (outsourcing) costs: Details on commission payments and binder fees to enable monitoring of regulatory caps.
- Claims management: Information on claims experience including repudiations to ensure fair claims handling.
- Complaints handling: Complaints management information to assist in identifying trends, root causes for complaints and areas for improvement relating to products sold or services rendered to the customer.
- Add-on/rider benefits.

At an aggregate level, insurers are required to provide the following information, split by policy type:

- Business composition:
  - Number of polices in-force and sold and their gross premium
  - New policies sold and policies not taken up, split by income of policyholder (low, medium, high)
  - Number of new policies sold and gross premium and policies not taken up, split by marketing channel
  - Details on cancelled policies
  - Lapsed and surrendered policies, split by duration in-force, income of policyholder (low, medium, high), marketing channel
  - Policies that have matured, split by income of policyholder (low, medium, high) and marketing channel
- Commission, binder fees and other payments:
  - A breakdown of commission per marketing channel
  - All payments and profits shared to non-mandated intermediaries and underwriting managers, split by binder function
- Advertising and marketing spend: Total spend split by type of media.
- Complaints handling: Detailed breakdown of categories detailing the reason for a complaint; and an indication of complaints finalised and outstanding.
- Add-on benefits: Details on the take-up of add-on benefits offered with products.

For individual products, insurers are required to provide additional information, split by benefit offered:

- Business composition: Policies in-force; new policies and cancelled policies.
- Claims management: The value and number of claims reported, paid, repudiated and outstanding for the financial period in question.
- Complaints handling: A breakdown of the claims received, split between policy design or service, policy performance, policy accessibility, changes or switches and lastly the insurer’s complaints process itself.

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CONTACT

Karl Murray
karl.murray@milliman.com

Eamonn Phelan
eamonn.phelan@milliman.com