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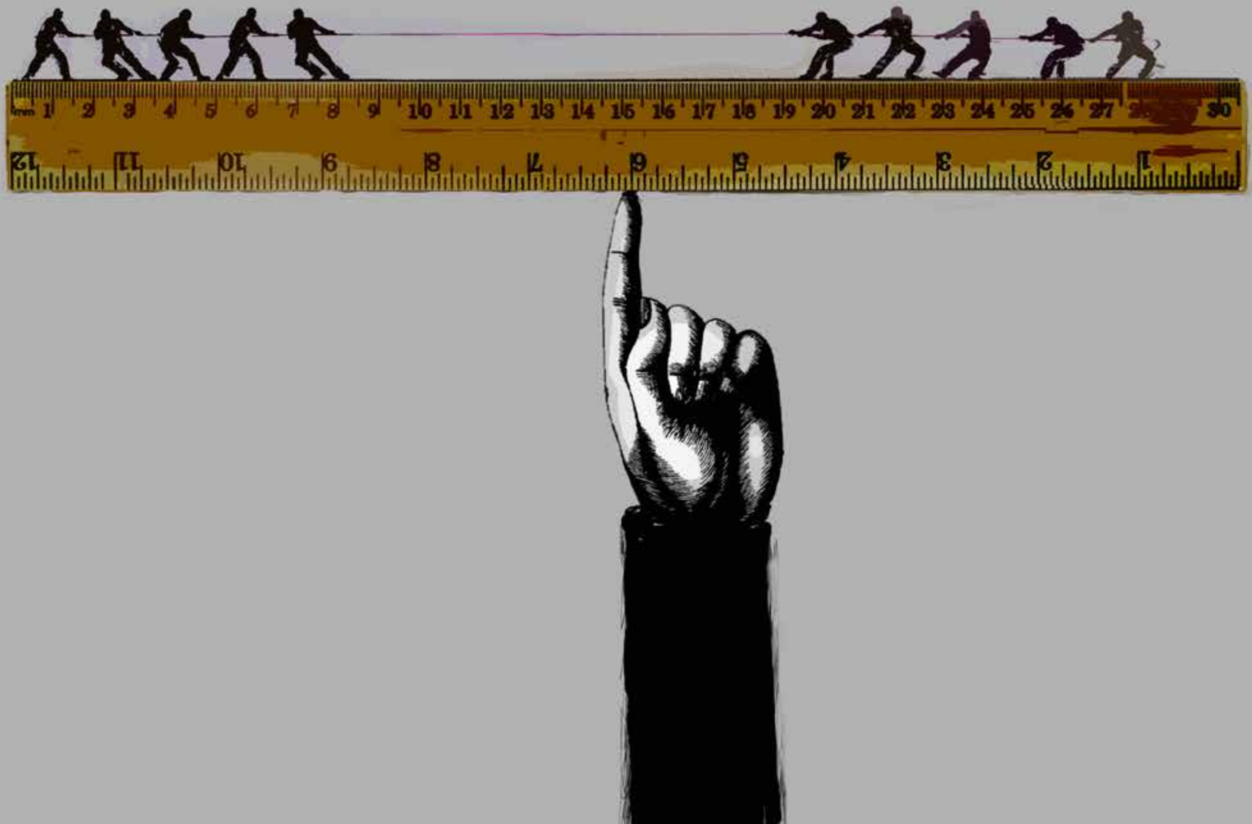
ACTIONABLE INSIGHT FOR BUSINESS LEADERS / **CONDUCT RISK** / JULY 2016

A LEVEL PLAYING FIELD:
CONDUCT RISK IN EUROPE



With Solvency II finally complete in terms of the rules, regulations and legislation, insurance firms were just getting to grips with the various implications for major product lines and different countries when the UK voted to leave the EU. Despite this uncertainty, a new agenda around conduct risk continues to gain traction – so what will this mean for Europe's insurance sector?

By David Worsfold

Regulators are restless entities. They constantly review strategies, create new agendas and throw out new challenges to those they govern; those shaping the future of Europe's insurance sector are no exception.

"Whether it is industry-focused regulators such as the European Insurance and Occupational Pensions Authority (EIOPA) and the increasingly important global regulators around the Financial Stability Board (FSB), or co-legislators such as the EU's Financial Stability, Financial Services and Capital Markets Directorate, regulators want to be seen to be in control of the markets. This is a legacy of the failure to predict or prevent the global banking collapse of 2007-08. Regulators now share a collective determination not to be caught out again and the UK's Brexit vote will most likely reinforce that resolve," says Michael Culligan, principal at Milliman.

This fear of failure drives them from one agenda to the next, often embarking on the next big change before the last one has been completed. This is precisely where the European insurance sector finds itself in 2016, even without the huge additional complication of addressing how – maybe even if – the UK leaves the EU.

"After more than a decade of preparation, meticulous debate and not a few false starts, Solvency II was finally enacted at the beginning of January, ready to be transformed into a broader rolling agenda around financial stability," explains Oliver Gillespie, principal at Milliman. "There are, however, a handful of unresolved key issues, including the treatment of infrastructure investments and securitisation, and the debates on the 2018 review of Solvency II were already starting in earnest. This review may be one of the casualties from the referendum as the Commission and EIOPA are going to be significantly distracted by the need to address a wide range of issues associated with the UK leaving the EU," he adds.

Consumer protection

Alongside this is a whole new agenda opening up around conduct regulation. This shouldn't come as a surprise to the insurance sector because it is precisely the path that banking has followed with the FSB and the International Organisation of Securities Commissions pushing conduct risk as a key issue from the middle of 2014, before the full implementation of the Basel 3 regulations, associated reporting and stress testing.

Globally, regulators are increasingly focused on consumer protection and mis-selling issues. "The UK and the US are ahead of the game when it comes to risk-based reporting and building regulation around the concept of consumer detriment, but many other markets, especially in Asia, are also looking to address these issues. They want to be seen as good places to do business and so are aligning their regulatory approaches with those of the more developed markets," highlights Neil Cantle, principal at Milliman.

The new focus on conduct risk in Europe was highlighted by the chair of EIOPA, Gabriel Bernardino, at the organisation's fifth annual conference in Frankfurt last September.

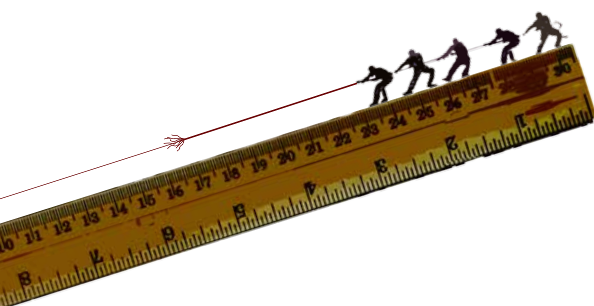
"A strengthening of conduct of business supervision is important for consumers, for insurance undertakings and for the market as a whole, as it promotes the orderly functioning of markets resulting in a level playing field, a healthy competitive environment, increased consumer confidence and financial stability. An effective and efficient conduct of business supervisory framework contributes to a credible deterrence of market misconduct and allows for pre-emptive and proactive supervision by acting before a developing issue becomes widespread.

"There has been significant reputational and financial damage as a result of consumer mis-selling scandals in the EU. Moreover, there has been a material loss in consumer confidence, compounded by existing information asymmetry and lack of financial education on the part of consumers.

"There is a clear need for a more consumer-centric culture in firms – senior management needs to take on more responsibility to prevent poor product oversight and misaligned incentives for sales staff. Traditional approaches to conduct of business regulation and supervision, focused on point of sale – disclosure and selling practices – and a 'tick-box' approach, have proved insufficient to prevent mass mis-selling," said Bernardino.

Tone from the top

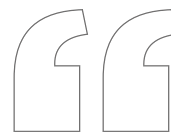
The need for senior management leadership will be key. The FSB identified the 'tone from the top' as a key indicator of the risk culture in major financial institutions in its initial report on conduct risk strategies in April 2014, and this has been embraced by the International Association of Insurance Supervisors and by EIOPA.



In particular, EIOPA has warned that the failure of many institutions and regulators to make the connection between conduct and prudential regulation has been a source of weakness in the past. It makes it clear in its *Strategy towards a comprehensive risk-based and preventive framework for conduct of business supervision* (published in January 2016) that "the interlinkages between conduct risk and the financial soundness of insurance undertakings and the stability of the financial system as a whole" will be a key focus as this agenda develops.

"In essence, it is about much more than the sales processes of individual insurance companies and intermediaries or even the potential reputational damage to the insurance industry. It is about ensuring financial stability and preventing any cross-contamination from poor conduct, whether that be product design, inappropriate sales incentives, poorly trained staff or inadequate monitoring," outlines Gillespie.

Financial stability is one key driver for this new focus on conduct risk but alongside that is the need to bring regulators across the EU up to scratch. This isn't just



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Gabriel Bernardino, chair, European Insurance and Occupational Pensions Authority (EIOPA)

EU CONSUMER AGENDA

The European Commission's Green Paper on *Retail financial services: better products, more choice and greater opportunities for consumers and businesses* – originally announced in the Capital Markets Union Action Plan [IP/15/5731] – is high level and wide ranging. It doesn't put forward policy proposals, but seeks views on improving products, choice and opportunities for firms and consumers across insurance, loans, payments and savings accounts and other retail investments.

The paper starts from the assumption that in the EU there are fragmented markets and insufficient competition, limited cross-border activity, differences in price and choice across member states and minimal consumer switching.

"In practice, this means that many Europeans may not be enjoying the widest range of products or they are paying over the odds," says the European Commission.

The consultation also considered the impact of digital technology on the market. Digital services such as online banking, peer-to-peer lending or price comparison websites present many opportunities for the providers and consumers, but can also pose a regulatory and consumer protection challenge.

The Green Paper complements other EU Commission initiatives, such as the Capital Markets Union, the Digital Single Market and the Single Market Strategy.

The focus in the Financial Stability, Financial Services and Capital Markets Directorate remains on improving growth and the single market and removing barriers to digital innovation, say officials despite the upheaval caused by the abrupt resignation of Lord Hill, the UK Commissioner in charge, and his subsequent replacement by Valdis Dombrovskis, the Latvian Commission vice-president.

"Making it easier to sell into other Member States will increase opportunities for financial services firms. Increasing transparency in pricing and access by consumers to products in other countries might also, in the long term, have an impact on pricing and competitiveness," says Oliver Gillespie, principal at Milliman.

The consultation closed at the end of March and the Commission originally envisaged publishing an Action Plan on Retail Financial Services later in 2016, possibly preceded by a conference of interested parties. This timetable is likely to slip in the wake of the UK referendum result and it now seems unlikely that the conference will take place this year.

a concern for EIOPA but is also firmly aligned with the broader political agenda with the Capital Markets Directorate currently consulting on a very consumer-focused agenda for the whole sector (see box above).

EIOPA is very clear on what it sees as the problem – and the urgency of finding a solution:

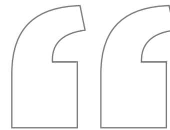
"Some National Competent Authorities (NCAs) have long-standing experience and broad mandates, including comparably huge resources, undertaking consumer surveys, extensive thematic reviews, sophisticated monitoring frameworks, including mystery shopping, etc.

"At the other end of the scale, there are examples of NCAs only recently embarking on the topic of conduct risk as a new and evolving theme. Irrespective of the underlying differences in national market structures, the consequence is that similar issues may be treated in different ways to the detriment of consumers and at the risk of lack of convergence across the EU.

"Considering the highly fragmented situation across the EU, the different NCAs' approaches, current status and available resources for addressing conduct of business supervision in member states, convergence across the EU should take these differences into account. However, this does not imply moving at the pace of the least developed approach."

Removing market barriers

Thematic reviews have been a favoured tactic for the UK's Financial Conduct Authority (FCA). They are used to targeting a specific financial activity or product that is feared to be causing consumer detriment or creating a barrier to the effective functioning of the market.



Poor conduct can be caused by deliberate actions or may be inadvertent due to inadequacies in an organisation's practices, frameworks or education programmes.

Chris van Homrigh, Australian Securities and Investments Commission

"They have the advantage of being very focused and relatively quick when compared to previous regulatory approaches which have involved extensive, in-depth and lengthy investigations. The FCA has used them to warn regulated firms to address a problem, giving them a chance to act without heavy regulatory intervention. When that warning hasn't been heeded intervention can follow quickly," says Culligan.

EIOPA wants to use thematic reviews in a cross-border context to "help to explore issues that go beyond one national market, either because those issues have a cross-border element to them, or because they arise in several national markets. This approach would build a coordinated understanding across those markets and be beneficial for European consumers."

The pan-European regulator has moved quickly in the weeks following the UK's referendum to demonstrate its determination not to be deflected from this agenda by announcing that it is conducting a thematic review of the unit-linked life assurance market. It has raised concerns about the relationships between insurers and asset managers and is expecting insurers to report through their national regulators by the end of September. This is likely to be the first of several similar reviews as EIOPA hammers home the "business as usual" message while the Brexit negotiations are pursued by the politicians.

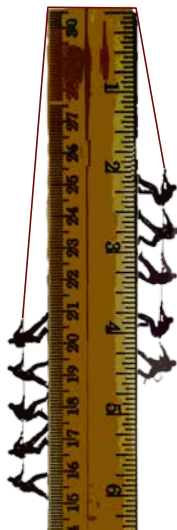
How can insurers prepare themselves for this new focus on conduct risk?

Perhaps looking at some of the tools developed by the major banks would be useful, although banks admit they have struggled to define it, partly because regulators have been reluctant to provide definition as they don't want it put into another silo, as Chris van Homrigh, from the Australian Securities and Investments Commission recently explained to Risk.net.

"Conduct risk is essentially what you do, why you do it and the implications of those actions. It's also when you don't do something. That is, when you see something does not look right and do not escalate the matter appropriately for action. Poor conduct can be caused by deliberate actions or may be inadvertent due to inadequacies in an organisation's practices, frameworks or education programmes."

Many of the major banks have already appointed someone at director level responsible for conduct risk, including UBS, Barclays, HSBC, RBS and Citi, in order to demonstrate that they are providing the right 'tone from the top', highlighted as necessary by the FSB. They are also creating multi-layered reporting strategies which help them search for anomalies in quantitative and qualitative data. As well as searching through the obvious indicators of potentially flawed conduct such as distorting sales incentives, product churning, fraud and sudden changes in business flows, this also means looking at staff and intermediary turnover, disciplinary events and client feedback.

For EIOPA one of the key challenges for the industry will be keeping pace with new risks and not dealing with conduct and prudential regulation in separate silos, but seeing the two as inextricably linked.



EUROPE ISN'T KIDDING ON CONSUMER PROTECTION

The determination of the European Commission to raise the bar on consumer protection has been amply demonstrated already with Packaged Retail and Insurance-based Investment Products (PRIIPs).

It has taken seven years, but at the end of 2016 anyone advising on or selling these products will have to provide a highly standardised Key Information document (KID) to clients. Investment advisers are already familiar with this concept as it has been in force for UCITS (Undertakings for Collective Investment in Transferable Securities) for some time, but it is now being extended to a much wider range of investment funds, life insurance plans with an investment element, structured products and structured deposits.

The intention is to improve transparency and make it easier for consumers to compare products. The European Commission has employed behavioural economics in creating the blueprints for the KIDs, a technique that it will probably turn to as it develops the next generation of consumer protection policies. The Commission has shown that it will not respond to what it sees as attempts to water down its approach, despite strong resistance from practitioners, including Insurance Europe. The European Commission approved the regulatory technical standards (RTS) for PRIIPs at the end of June, provoking stinging criticism from Michaela Koller, director general of Insurance Europe.

"It is extremely disappointing to hear that the Commission has adopted these RTS, despite the fact that they contain serious design faults. These problems have been reiterated again and again to the Commission by various stakeholders, and yet it has chosen to go ahead regardless, without a single change being made to address the faults.

"This means the key information document, which the RTS provide for, will not achieve its aim of informing consumers and helping them to compare products. In fact, it will ultimately mislead them, because it makes insurance products appear more expensive and riskier than they actually are. It should be noted that this goes directly against the aims of the Commission's much welcomed Better Regulation agenda."

This debate will now be taken to the European Parliament which has to approve the RTS in order for them to come into force by the end of this year.

"PRIIPs is not the only initiative already in motion that seeks to strengthen investor protection. MiFID II [Directive on Markets in Financial Instruments repealing Directive 2004/39/EC] is also bringing in extensive product governance rules and a definition of independent investment advice, an approach that is well established in the UK but less familiar in other markets. These are all part of the very consumerist approach towards financial services being adopted by the Commission and which we can see it won't be easily deflected from," says Neil Cantle, principal at Milliman.

"Conduct issues not only harm individual consumers, but can have wider prudential impact as seen with the Payment Protection Insurance mis-selling scandal [in the UK]. Indeed, at national level, there are different approaches to addressing conduct risks with differences in priority setting and levels of resources allocated. These divergences in models and practices across the EU only help to reinforce the current fragmented situation.

"The interrelationship between conduct and prudential issues plays a key part, on the one hand, regarding the sometimes conflicting goals and tension between the two, and, on the other hand, the fact that the ultimate objective of a prudential framework such as Solvency II is the protection of policyholders. Moreover, poor conduct of business – such as mass mis-selling – can have a systemic impact on the market, that is contributing to the development of systemic risk."

Find out more

Michael Culligan
+353 1 6475903
michael.culligan@milliman.com

Oliver Gillespie
+44 20 78471500
oliver.gillespie@milliman.com

Neil Cantle
+44 20 78471537
neil.cantle@milliman.com

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