Leading in an era of intensive conduct supervision

Insurance Governance Leadership Network

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ViewPoints

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> A lot of the work since the crisis has focused on strengthening the resilience of our institutions and infrastructure. As this work nears completion, the spotlight is shifting. It is shifting towards market practices, industry culture, and individual behaviour.
>
> – Martin Wheatley, Chief Executive, Financial Conduct Authority[1]

In virtually every part of the world, the financial crisis sapped public trust in financial institutions. New regulations and regulators were created to more explicitly protect customer interests. Conduct supervisors increased the intensity of their scrutiny and began to impose previously unprecedented fines. Before the crisis, supervision typically focused on rules or principles; today, supervisors worry about consumer outcomes. This has proven to be a challenging aspiration for both supervisors and insurers. Good outcomes are often subjective. They can be influenced by factors outside of insurers' control, and the quality of an outcome may take years to determine.

Nonetheless, the intensity of conduct regulation and the emphasis on outcomes continues to grow. The UK's Financial Conduct Authority (FCA) and the Dutch Authority for Financial Markets (AFM) appear to be moving fastest among supervisors, but other countries are watching and their approaches are likely to be widely imitated.

> *"Many directors are curious, where is the supervisor going and how well do we really understand it?"*
>
> *– Director*

To date, banks have faced the most public and supervisory scrutiny, but insurers have not been immune. Indeed, in the words of one director, *"It would be foolish to think insurers will not face what banks have faced. Perhaps it will be to a lesser degree, but the wave is coming."*

On 16 September and 9 October 2014, insurance directors, executives, and regulators gathered to discuss this new era of supervision and to consider practical approaches for addressing conduct challenges. During these conversations, several key themes emerged. This *ViewPoints*[2] centers on four of these themes:

- Global insurance groups are increasingly prioritizing conduct and related risks
- Conduct standards and expectations are not yet well defined
- Boards are redefining their conduct responsibilities
- Strong culture is the foundation of good conduct

Global insurers are increasingly prioritizing conduct and related risks

"At the heart of it, conduct is a local issue. You operate to the local standard, but if you are a global organization, how do you square that across the group? What is the group

approach?" one executive asked. IGLN participants noted that boards and executives are devoting significantly more time to developing organizational approaches to improving conduct and mitigating associated risks.

Several factors are driving conduct up the board agenda

Consumer-focused regulations, recently drafted in a relatively small number of locations, appear to be driving conduct and conduct risk higher on the agendas of boards around the world. Conduct is an increasingly important risk. One CRO noted, *"I probably spend 20 to 30% of my time on conduct issues with the FCA, focused on both new products and on legacy products and challenges. That is 30%, and we're in the good boat according to the regulator."* To date, conduct issues have largely been associated with the retail market; however, conduct regulators also have clear jurisdiction over insurers with a commercial focus. In the United Kingdom, for example, Lloyds has developed new conduct requirements for participants in its market. FCA activities in the banking sectors related to Libor, foreign-exchange issues, and swaps and derivatives markets also show a clear concern for market integrity as much as retail and commercial customers.

IGLN participants identified three main elements of conduct supervision that are causing boards to refocus their efforts.

- **Shifts from a rules-based to an outcomes-based regime.** Ensuring that product value stands up to scrutiny over time is a new challenge for both regulators and insurers. According to one audit chair, *"It is easy to say that we followed the rules. It is quite another matter to demonstrate that customers received value for money and a fair outcome. That requires a long audit trail."* Furthermore, external factors, such as the economic climate, could influence product performance in ways that create worse outcomes for customers outside the providers' control. Failure to demonstrate fair outcomes, despite positive initial intent, could still result in misconduct claims.

"How do you demonstrate fairness? Yes, transparency is essential, but beyond that?"
– Executive

- **Possible challenges to existing and future business models.** New regulations may be at odds with long-established practices. A greater focus on equality – as, for example, in the European Union's gender directive[3] – may make accurate risk-pool pricing more difficult or may shift risks to other members of more broadly defined pools. The explosion of "big data" technology enables ever-more accurate and sophisticated underwriting and pricing. These developments could outstrip regulators' review and oversight or the public's appetite for digital surveillance, or they could lead to claims of discrimination or disparate impact.[4]

- **Reputational and financial risk.** *"Every fine for a bank or insurer is major news,"* said one director. He went on to say, *"The reputational risk is a huge concern. Of course, the size of the fines is, too."* In many recent examples, fines more than eliminated any profits that resulted from the activities or products in dispute, even before reputational costs are considered. Furthermore, there is a sense among many in the industry that fines are uncapped and there is no mechanism for appeal.

Large, complex insurers, regardless of where they are domiciled, are taking action on conduct

Dutch and UK-based insurers have been experiencing more intensive supervision for some time. Recent European legislation suggests that other European players will soon see this as well. One UK director pointed out, *"Controls are driving conduct thinking… [but it] is increasingly embedded in our thoughts about strategy."* Somewhat in contrast, a US-based participant noted, *"Frankly, consumer protection has been a low-level matter for our board. It is really a compliance issue, rather than a significant focus."* Despite differences in each board's historic approach to the issue, and the varying levels of intensity with which local regulators pursue conduct, there was a general acknowledgement that in the future, insurer conduct and related financial and reputational risks will feature more prominently in board discussions. As conduct becomes more important in locations where insurers have significant operations, groups will be looking to strengthen both local and group approaches to conduct.

Conduct standards and expectations are not yet well defined

IGLN participants agreed that defining "good conduct" remains difficult and that the scope for potential misconduct is broader than it once was. Where conduct regulation was once largely confined to obvious anticompetitive behavior (e.g., price fixing), it now includes sales practices, product design and assumptions, and organizational culture, among other things.

"Our organizations need more guidance in this area. We need generally accepted principles."
- Director

Supervisors and the industry have not yet come to a clear and shared understanding of the principles that govern the supervision of conduct, but there is a growing recognition that better principles are needed. Generally, insurers seek more clarity and substance regarding conduct standards, because they are keen to prioritize conduct-related activities. *"Tell us your standards. What do you think constitutes good or bad conduct?"* one director asked a regulator.

Supervisors, in contrast, argue that the goal is good outcomes, which cannot be assured simply by adherence to rules or standards. Furthermore, as the history of the UK's Treating Customers Fairly (TCF) principle illustrates, narrow definitions and lists of acceptable or unacceptable practices can lead to market participants' gaming the system, or to the degeneration of regulatory compliance into tick-box exercises. One regulator pointed insurers to recent enforcement actions for clarification, but also noted that supervisors could do more work to distill *"what 'good' looks like."* He continued, *"We have to be clearer about the principles we are developing."* Insurers and regulators are eager to continue engaging on this topic.

In this new area of conduct supervision, three critical questions emerge:

- **What is an organization's responsibility to educate customers?** This question encompasses several broad themes, including fairness, caveat emptor (buyer beware), and customer sophistication. How far does an insurer's, or their intermediary's, responsibility extend to ensure that customers understand products and accept the associated risks? While participants agreed that companies should not sell products to customers who do not understand them, they also acknowledged that assessing sophistication is difficult. One director asked, *"What do you do with a customer who wants products you are not sure they understand?"* How should companies guard against "misbuying" by consumers, and what is the provider's responsibility?

The financial literacy challenge

Low levels of financial literacy and, perhaps, desensitization to the ways in which information is provided create additional conduct risks for insurers, and for the public more broadly. *"People just click, click, click, without reading and have no idea what they are taking on,"* reported one director.

It is increasingly difficult for insurers to assess the suitability of products for customers, and for individuals to understand the risks they are encountering directly or by opting out of a product purchase. One expert noted, *"With the end of annuitized savings in the UK, people who have £30,000 pension pots will have to decide what to do. Do they spend half, invest the rest, and hope for the best?"* Ultimately, the cost of insufficient savings may be borne by individuals, families, and governments. Participants noted a role for insurers in providing additional financial education, but also a need for civil society, through schools and other means, to increase financial literacy.

- **Are some traditional marketing or sale practices inherently unfair?** Several directors acknowledged that historic practices, such as bundling products, offering differential pricing (such as front-book versus back-book pricing), and using profits from one product to subsidize another, while strategically useful, made it more difficult for customers to understand pricing. One director noted, *"The practices may make sense, but they also left us wide open to misselling."* Regulators, likewise, acknowledged that these types of offerings could exploit consumer biases. Several recent FCA reviews examined profits related to differential pricing for new and existing annuity customers, as well as the impact of bundling and product add-ons. An FCA spokesperson said, "[S]ome providers might have been benefiting from consumer inertia … with several insurers having retention of annuity business as part of their business strategy."[5] One executive summed up the business model implications saying, *"We haven't always been clear with ourselves on the economics. Are some products, and by extension some customers, subsidizing others? To some extent that is what a risk pool is. However, do products depend on customers not fully understanding the value that accrues to them?"*

"Why is the customer buying the product? Is the product or the sales process generating demand? These are basic questions boards should ask."
- Regulator

Behavioral economics and predictable error

"Problems often arise because firms' product design and sales processes may accentuate, rather than ameliorate, the effects of consumer biases." - FCA[6]

- **Defining behavioral economics**. Behavioral economics, a recently developed branch of the discipline, recognizes that customers make predictable errors in choosing products and services. They may be irrationally risk-averse, or they may forget that an attractive introductory price becomes uneconomical once the introductory period is over.

- **The view of the FCA.** In 2013 the FCA published its first report on behavioral economics, wherein it identified ten common consumer biases that firms are likely to exploit, suggested ways that firms can avoid exploiting customer biases, and discussed areas where the FCA could intervene. These biases included tendencies toward loss aversion, oversimplification, and immediate gratification.

  According to FCA Chief Executive Martin Wheatley, "[B]ehavioural economics is quickly becoming a game changer. Not just for firms, not just for consumers, but potentially for the shape of regulation for many years to come."[7] The FCA intends to continue to use behavioral economics and related "nudges" to challenge customer bias, understand firm behavior and stimulate competition.

- **Are some highly profitable products inherently unfair**? *"There is a growing view that regulators think it is bad if companies make a profit. If you profit, that means someone is disadvantaged,"* noted one director. In response, a supervisor said simply, *"We aren't here to regulate profits."* However, he went on to say, "*If a firm is making super profits, we have to question the health of the business model."* Regulators are not opposed to insurers making profits, but they view unusually high profits as possible indicators of questionable practices. Both prudential and conduct supervisors indicated that operating profits and the bottom line need to be sustainable and that pushing the limits of conduct risk as part of the business model was not likely to qualify. One regulator asked, *"Is the board truly clear on how much the business depends on taking conduct risks, and how embedded that is in the product strategy?"*

"Some products are long on margins, low on loss and high on commission. It doesn't mean customers are getting a raw deal, but there could be some issues there."
- Director

Boards are redefining their conduct responsibilities

For leading insurers, getting conduct right is about compliance and mitigating risk but, more profoundly, it is about enhancing the relationship with customers and, perhaps, creating a competitive advantage. To do this, boards are rethinking operations from the highest levels of the board down through the front line. As one director noted, *"It is difficult for boards to manage all of this. Is it even the role of the board? I think the board has to see that the right processes are in place to address these sorts of issues."*

- **Boards must balance their demand for details with their oversight role.** As one director said, *"You can't load up on everything. You only have so many hours per year. Boards need direction. We get criticized for doing too much and doing* *too little. The main issue is what should the board focus on?"* Conduct, and related regulation, is one of many issues requiring more time and attention from boards. Individual directors and whole boards face increasing pressure from regulators and shareholders to get more "into the weeds." Participants agreed that boards are spending more time simply defining what is within, and outside of, their scope. Several participants also noted that, as boards further articulate their roles and responsibilities, they should engage more actively with stakeholders to explain their actions and decisions.

"Fines and compliance costs are increasing. As a board, you look at that and say, 'Okay, what do we need to do differently?'"
- Director

- **Insurers are clarifying the roles and responsibilities of the local and the group boards**. For some insurers, this has meant reconfiguring existing committee structures or creating new ones to address conduct and related risks. Directors broadly agreed that the group board should set conduct principles. However, local boards will always play a significant role because they are closer to customers, culture, and local needs. While some participants extolled the virtues of a bright line on some products, one director asked, *"If we won't sell it in one place, why is it okay to sell it in another?"* Other participants noted that products need to be responsive to local needs.

  To manage conduct effectively, insurers are clarifying protocols for escalating the most important issues. One audit chair said he speaks with the lead engagement partner weekly and *"if there are problems, I get on a plane."* Another director said, *"If there is significant financial or reputational harm, it is an issue for the full board."* Several committee chairs described processes by which subsidiary committee minutes roll up to the group committee.

- **Conduct is becoming a core strategic issue shaping frontline business decisions.** Boards that have focused less energy on conduct have tended to view it as a compliance and risk issue only. Over the course of recent IGLN meetings, it became more evident that many regulators, and increasingly more insurers, view conduct as a core strategic and business model issue – something squarely within the purview of the board. In light of this recognition, insurers need to revisit business models that could take advantage of customer biases or information deficits. Regulators agreed that treating conduct as a compliance exercise was not the right approach. In comparison with the UK's prior conduct regime, which was heavily focused on TCF principles, one supervisor said, *"TCF was a trap. It became all about having the right management information. You have to start from the design of the business."*

"I think good conduct is as much about behavior as control systems. It is a holistic way of thinking about it. If the goal is to reduce risk, then you could miss the point."
- Supervisor

- **Boards must develop and test unambiguous conduct principles.** In addition to defining roles and responsibilities, several directors agreed with one who observed, *"Setting the standards is job one. Everything flows from that."* While directors do not want to micromanage, most agreed that establishing group-level principles for conduct was a core part of a board's responsibility. Beyond standard setting, one director noted, *"How do you prove to yourself that things are working well? You have to test. As an industry, I don't think we are there yet. We are satisfied with the creeds and standards. The next phase is testing if all of this is really happening."* On the topic of guardrails and metrics, one executive countered, *"We have a zero* *tolerance. There is no appetite for conduct risk."* Whether or not groups maintain limits for conduct risk, key performance and risk indicators play an important role in the ongoing assessment of conduct. So, too, does *"getting out and kicking the tires,"* said one director. It is important for board members to visit different venues and business lines to evaluate how local strategies and local leaders are treating customers.

"Our policy is to go with the highest standard – either the local or global – whichever is greater." - Executive

Strong culture is the foundation of good conduct

For a number of directors, organizational culture is at the heart of improving conduct. As one director said, *"No standards or processes will protect you from a culture run amuck."* Accordingly, a key part of any organization's conduct journey must be to evaluate and create a supportive culture. However, organizations continue to struggle with how to establish and maintain the culture they want. Participants identified four elements necessary to strengthen organizational culture in order to improve conduct:

- **Setting a clear tone from the top.** "Tone at the top" may be a buzzword, but directors widely acknowledged the importance of a consistent and strong message from an organization's top leaders regarding its values and priorities. Participants also widely believed that their boards and executives are focused on setting this tone. While individual cultures will vary, IGLN participants believe the essential attributes of a strong culture include, but are not limited to, customer centricity, ethical behavior, the ability to challenge and question, and a desire to learn from opportunities and challenges. One participant asked, *"Can the board meet different members of management or key clients? This starts at the board and must work down into the company."*
- **Aligning incentives and desired conduct.** Several boards are reevaluating deferral periods, vesting, and overall compensation for top individuals, both in a desire to align conduct and culture and in response to regulator and shareholder pressure. Some firms are extending this review to the front line as well. Insurance leaders widely acknowledge that compensation and incentive schemes play an important role in supporting organizational culture. *"Are remuneration practices based on pushing product?"* asked one director. For long-tail product providers, incentives can be misaligned because *"most problems occur long after the fact,"* said one participant.
- **Addressing problems swiftly and dynamically.** While often outside of the board's immediate area of responsibility, several participants noted that boards must feel confident that problems are swiftly uncovered and addressed. Enforcement of the values and clear accountability are essential. However, as one director said, *"Bad things still happen and that consumes a lot of the board's time. You have to know something will still happen and be prepared to proactively respond."*
- **Insurers must engage stakeholders regarding conduct and culture.** In meeting conversations, IGLN participants cited numerous ways in which insurers can engage better with customers, shareholders, and regulators about the value they provide. Several suggested that insurers be more active in articulating their value to individuals and society more broadly. One director said, *"We have to do a better*

"I think we are sleep-walking into a significant social exclusion challenge." - Expert

job addressing the trust gap." Another noted, *"Even the financial markets don't always understand insurers' value. Better communication about value, business models, and conduct inside the company and to external stakeholders is essential."* Finally, several insurers felt that the industry as a whole, commensurate with its role as a force for market stability and growth, should be clear about potentially negative consequences of additional regulation. Specifically, pressure to reduce prices and simplify products could lead to greater financial exclusion as it becomes too costly for firms to serve some market segments.

How do groups measure culture?

Boards continue to struggle with evaluating the cultures of their organizations. Many participants agreed with one director who said, *"I genuinely believe most of us think we are doing the right thing, but how do you know? How do you measure culture?"* Another suggested, *"What gets measured gets done."* Customer and employee surveys, combined with key risk and performance indicators, offer useful, though incomplete, metrics. One executive spoke for several when they noted:

"There is no silver bullet. No single thing on a dashboard shows you the customer. You have to get out there and see the call centers and branches. Key risk indicators are useful, but it is hard to determine what it all means. But, there is value in causing conversations to happen at the local level. It is about building up stories and how you, as a company, react to them."

Several supervisors suggested that regardless of dashboards or management information, understanding conduct and culture is about clearly understanding customer outcomes and, more specifically, overall product fairness and customer satisfaction.

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It was clear from these discussions that there is more work to be done. As one executive noted, *"Those who have started down the journey of conduct know they have much further go. Sometimes that is difficult because you realize you just have to pace yourself."* Meeting participants acknowledged the importance of addressing remaining questions and identifying a framework that will give boards and regulators, as well as the general public, confidence that conduct issues are being addressed. Participants recognized the need for insurers and supervisors to move away from sometimes adversarial relationships, and towards a more collective approach to addressing conduct issues.

We hope that the IGLN can continue to serve as a useful forum to improve understanding on these important topics.

About the Insurance Governance Leadership Network (IGLN)

The IGLN addresses key issues facing complex global insurers. Its primary focus is the non-executive director, but it also engages members of senior management, policymakers, supervisors, and other key stakeholders committed to outstanding governance and supervision in support of building strong, enduring, and trustworthy insurance institutions. The IGLN is organized and led by Tapestry Networks, with the support of EY.

ViewPoints is produced by Tapestry Networks and aims to capture the essence of the IGLN discussion and associated research. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, senior management, advisers, and stakeholders who become engaged in this leading edge dialogue, the more value will be created for all.

About Tapestry Networks

Tapestry Networks is a privately held professional services firm. Its mission is to advance society's ability to govern and lead across the borders of sector, geography, and constituency. To do this, Tapestry forms multi-stakeholder collaborations that embrace the public and private sector, as well as civil society. The participants in these initiatives are leaders drawn from key stakeholder organizations who realize the status quo is neither desirable nor sustainable, and are seeking a goal that transcends their own interests and benefits everyone. Tapestry has used this approach to address critical and complex challenges in corporate governance, financial services, and healthcare.

About EY

EY is a global leader in assurance, tax, transaction, and advisory services to the insurance industry. The insights and quality services it delivers help build trust and confidence in the capital markets and in economies the world over. EY develops outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, EY plays a critical role in building a better working world for its people, for its clients and for its communities. EY supports the IGLN as part of its continuing commitment to board effectiveness and good governance in the financial services sector.

Appendix: Meeting participants

Aegon

- Dona Young, Non-executive Director, Audit Committee Member, and Risk Committee Member

AIG

- John Fitzpatrick, Risk and Capital Committee Chair and Audit Committee Member
- Steve Miller, Chairman of the Board
- Sid Sankaran, Executive Vice President and Chief Risk Officer

Allianz Insurance Ireland

- Jan Carendi, Non-executive Chairman

Aon

- Mike Losh, Audit Committee Chair

Aviva

- Bob Stein, Nominating Committee Member, Remuneration Committee Member, and Risk Committee Member

Assicurazioni Generali

- Sabrina Pucci, Non-executive Director

Authority for the Financial Markets

- Harman Korte, Executive Board Member

Direct Line Group

- Jane Hanson, Board Risk Committee Chair, and Corporate Social Responsibility Committee Chair
- Andrew Palmer, Audit Committee Chair, Investment Committee Member, Board Risk Committee Member, Nomination Committee Member, and Remuneration Committee Member

European Insurance and Occupational Pensions Authority

- Carlos Montalvo, Executive Director

Financial Conduct Authority

- Clive Adamson, Director of Supervision and Executive Board Member
- Louise Walker, Executive Assistant to Clive Adamson

Financial Stability Oversight Council

- Roy Woodall, Independent Member, Insurance Expertise

Lincoln Financial Group

- John Rhodes, Chief Risk Officer

MetLife

- Stan Talbi, Executive Vice President, Global Risk Management, and Chief Risk Officer

Old Mutual

- Sue Kean, Chief Risk Officer

Prudential Regulation Authority

- Andrew Bulley, Director, Life Insurance Supervision

RSA

- Alastair Barbour, Group Audit Committee Chair and Investment Committee Member
- Kath Cates, Non-executive Director and Risk Committee Chair

XL Group

- Kirstin Gould, Executive Vice President, General Counsel, and Secretary
- Rhic Webb, Managing Director and General Counsel

Zurich Insurance Group

- Monica Mächler, Non-executive Director
- Don Nicolaisen, Audit Committee Chair and Risk Committee Member

EY

- Andy Baldwin, Leader, Global Financial Services
- Shaun Crawford, Global Insurance Sector Leader
- Andreas Freiling, EMEIA Insurance Leader, Financial Services
- Ed Jervis, Leader, Insurance and Pensions Audit
- John Santosuosso, Americas Insurance Leader
- Steve Southall, Executive Director, Financial Services Risk
- Tom Ward, National Director, Insurance Regulatory Group

Tapestry Networks

- Dennis Andrade, Principal
- Leah Daly, Principal
- Jonathan Day, Senior Adviser
- Peter Fisher, Partner

Endnotes

[1] Martin Wheatley, "Modelling Integrity Through Culture" (speech at the FCA Markets Conference 2013, London, 19 November 2013).

[2] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of network participants and their corporate or institutional affiliations are a matter of public record, but comments are not attributed to individuals, corporations, or institutions. Network participants' comments appear in italics.

[3] The European Union Test-Achats judgment, effective December 2012, prohibits insurers from using gender as a rating factor when pricing risk or paying benefits.

[4] In the United States, "disparate impact," is a legal doctrine which holds that a policy or practice based on neutral criteria may nevertheless constitute illegal discrimination if it has a disproportionate adverse impact on protected groups.

[5] Rob Mannix, "Insurers Review Conduct Risk as FCA Targets Mis-selling," *Insurance Risk*, 16 May 2014.

[6] Financial Conduct Authority, *Applying Behavioural Economics at the Financial Conduct Authority* (London: Financial Conduct Authority, 2013), page 16.

[7] Martin Wheatley, "Making Competition King: The Rise of Behavioural Economics at the FCA" (speech at the Australian Securities and Investments Commission, 25 March 2014).