Conduct Risk in the Irish Market

Society of Actuaries in Ireland

Risk Management Perspectives Conference

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Building a better
working world

What is Conduct Risk and why is it important?

The risk that firms behaviour will result in poor outcomes for consumers

Firms need to ensure they are putting the consumer and the integrity of markets at the heart of their business models and strategies.

This includes making strategic cultural changes which promote good conduct, establishing oversight around the design and innovation of products and services; and ensuring they are transparent in their dealings with consumers.

Failure to do so

Reduced revenues

Regulatory scrutiny

Remediation costs

Reputational loss

Definitions of Conduct Risk

European Banking Authority	Conduct risk means the current or prospective risk of losses to an institution arising from inappropriate supply of financial services including cases of wilful or negligent misconduct. Source: EBA SREP Guidelines, 19 December 2014
Lloyds Bank	Conduct Risk is defined as the risk of customer detriment or censure and/or a reduction in earnings/value, through financial or reputational loss, from inappropriate or poor customer treatment or business conduct. Source: Lloyds TSB Bank Plc, Annual Report 2012
Santander	Conduct Risk is the risk that the business and operational decisions Santander UK takes and the behaviours displayed lead to poor outcomes for our customers. Source: Santander UK Plc 2013 Half Yearly Financial Report
International Association of Insurance Supervisors	Conduct of business risk can be described as the risk to customer, 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. Source: International Association of Insurance Supervisors, Issues Paper on Conduct of Business Risk and it Management, 17 June 2015
Central Bank of Ireland	Conduct risk is ‘the risk the firm poses to its customers from its direct interaction with them.’ Source: PRISM explained, November 2011

Conduct costs – Global issue / local issue

'Bank of America to Pay Record $16.65 Billion Fine (...to settle allegations that it knowingly sold toxic mortgages to investors.)'
Time Magazine, 21 August 2014

'Six banks fined £2.6bn by regulators over forex failings'
BBC News, 12 November 2014

Conduct regulatory enforcement actions in the headlines

'€67m refunded by banks over mis-sold PPI policies'
RTE News, 7 March 2014

Compliance is the minimum expected…Conduct Risk is wider than compliance with rules…Board members must ensure that Conduct Risk is on the Board's agenda every month '
Mick Stewart,
Central Bank of Ireland, 28 May 2014

'Banks face fresh wave of PPI compensation claims after landmark ruling'
The Independent, 28 May 2015

International conduct costs table

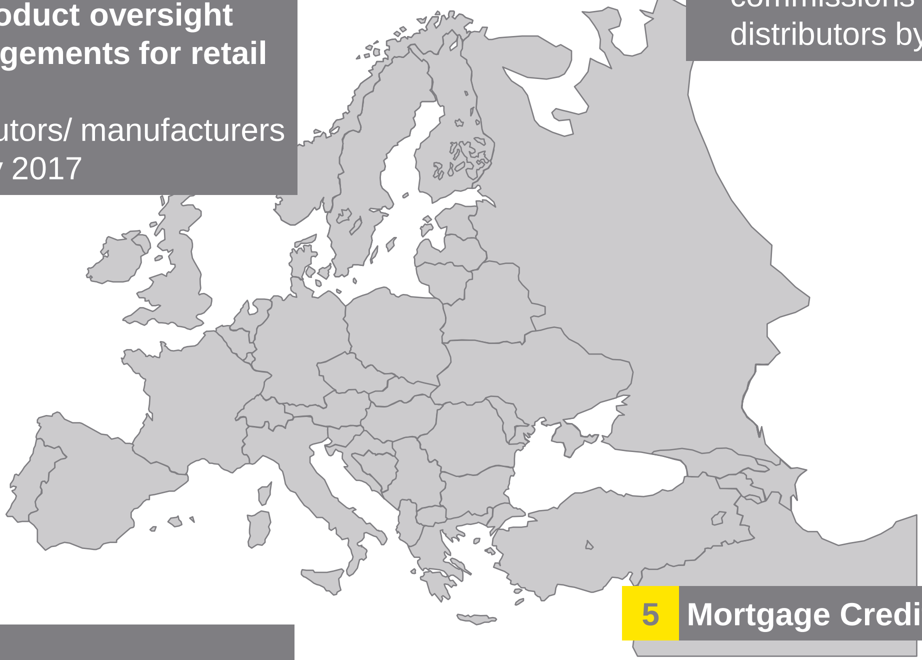
Banks	Total Costs 2009-2013 (GBP bn)	Provisions as at 31 Dec 2013 (GBP bn)	Grand Total 2009-2013 (GBP bn)
BAC	39.09	27.31	66.40
JPMC	26.61	9.17	35.78
LBG	8.91	3.82	12.72
RBS	3.54	4.92	8.47
Barclays	4.88	3.01	7.89
Citigroup	4.55	3.02	7.57
HSBC	4.97	2.24	7.21
Deutsche Bank	3.87	1.75	5.62
UBS	3.08	1.10	4.18
GS	1.48	2.17	3.65
Credit Suisse	2.00	1.58	3.58
Santander	2.42	1.14	3.57
TOTAL	**105.4**	**61.23**	**166.63**

[Source: CCP Research Foundation]

EU legislative drivers

1 MIFID II
- Product governance/intervention
- Distributor responsibilities

2 EBA Guidelines on product oversight and governance arrangements for retail banking products
- Guidelines for distributors/ manufacturers
- Apply from 3 January 2017



3 IDD
- Pre-contractual information requirements
- Member state may ban fees or commissions paid to insurance distributors by third parties

4 PRIIPs
- Key information document mandatory for specific products
- ‘Comprehension alert label’

5 Mortgage Credit Directive

6 Reform of the EU pensions regime

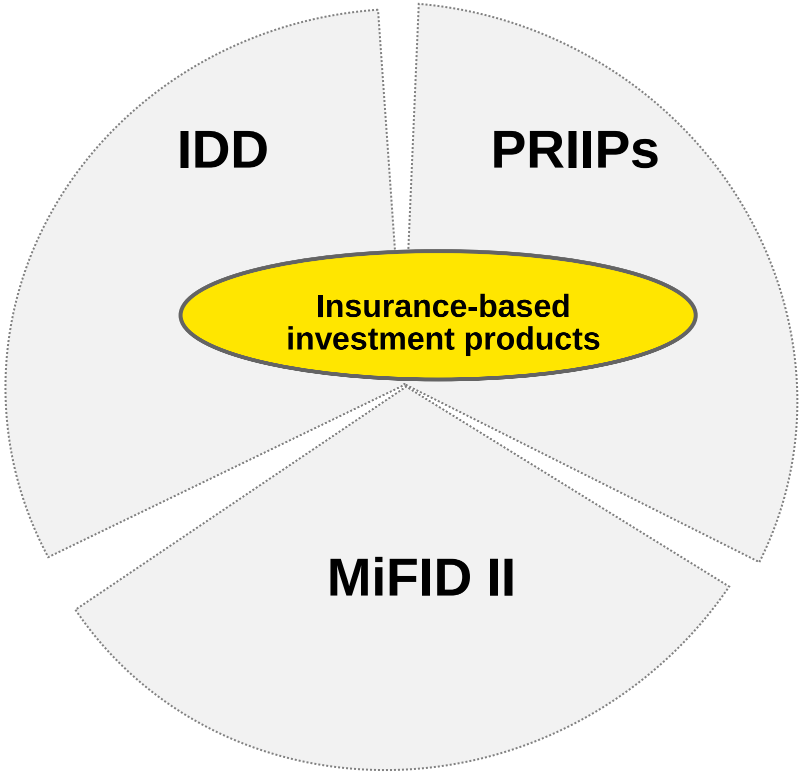
7 SSM and Conduct Risk

EU initiatives: IDD / PRIIPs / MiFID II

1	Common objective of the three initiatives: harmonisation of markets and products in the EU member states to ensure a level playing field and a high level of consumer protection.
2	IDD is the central set of regulations to improve consumer protection in the insurance sector; PRIIPs and MiFID II primarily affect providers of banking services.
3	PRIIPs and MiFID II are still of great relevance for the insurance sector, as both include specific provisions for insurance-based investment products (applies particularly to unit-linked and endowment life insurance).

EU initiatives: IDD / PRIIPs / MiFID II
Complementary rules on insurance-based investment products

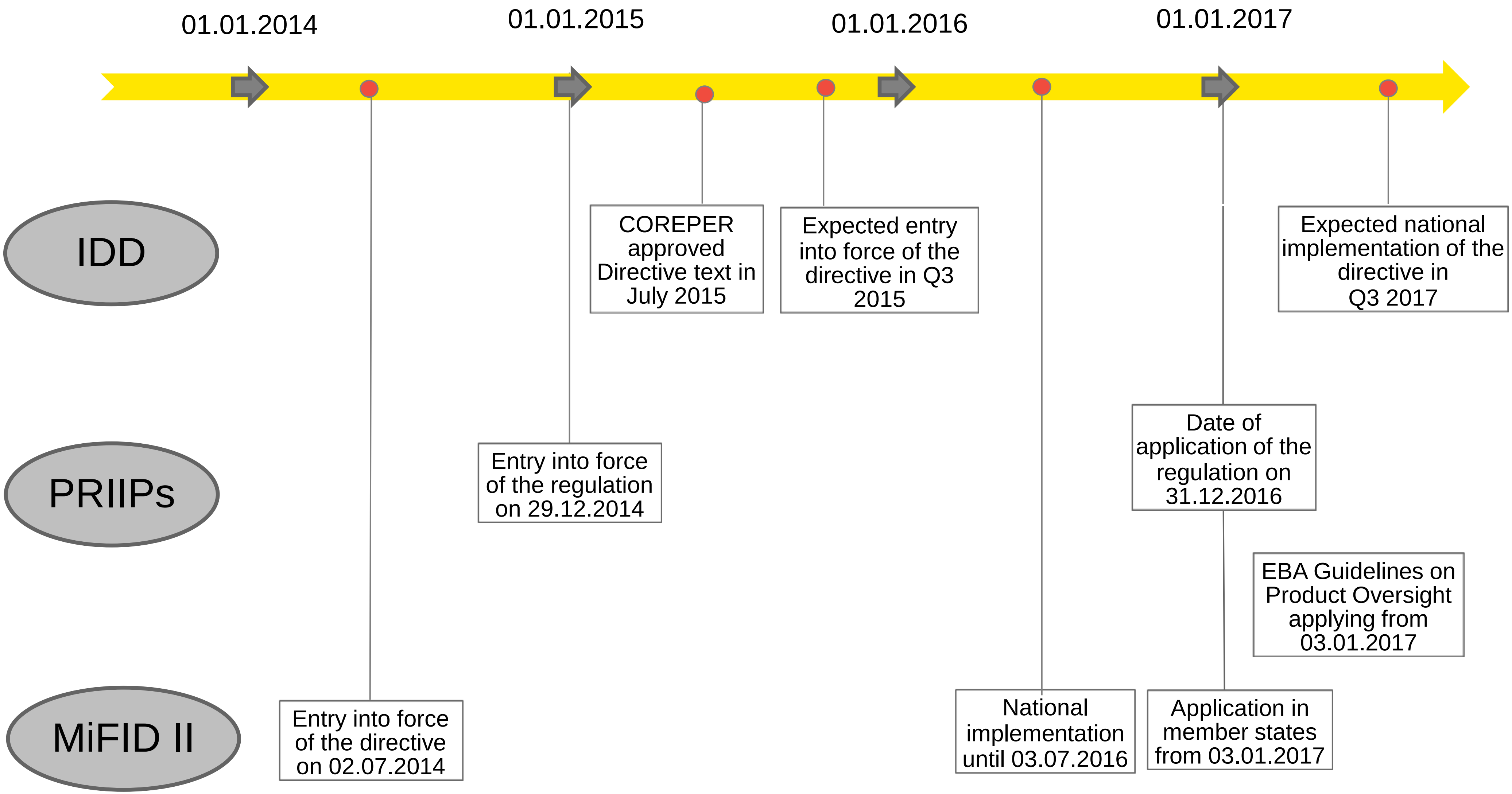
- Affects all insurance products (including insurance-based investment products)
- Extends the scope of IMD to all distribution
channels (including direct writers and aggregator websites)
- Current proposal covers, among other topics, continuing professional development of insurance distributors and disclosure of the nature and source of remuneration



- Affects only packaged retail and insurance-based investment products (PRIIPs)
- Regulation lays down uniform rules on the format and content of the key information document, which must be drawn up before a PRIIP is made available to retail investors

- Responsibilities of product providers and distributors
- Suitability and appropriateness
- Governance & remuneration
- Client disclosure, particularly regarding cost

Implementation Schedule of IDD / PRIIPs / MiFID II



CBI Conduct priorities that impact Insurance Sector

CBI has flagged some themes for the current year:

- Sale of long term products/pensions/handling conflicts of interest
- Systems failures and errors
- Oversight of outsourcing of core activities to third parties/agents
- Sale of products on an execution-only basis
- AML/CTF compliance
- PPI/Card and identity protection products
- Cyber Security / Operational Risk
- Regulatory reporting compliance
- Fitness and probity obligations
- Conduct of business under MiFID
- Variable remuneration requirements

CBI Conduct priorities that impact Insurance Sector

Bigger picture…….

……*there is a clear need for fundamental change in the behaviour of financial services providers towards consumers*

(Director of Insurance Supervision, 14 May 2015)

The CBI is focussed on developing a consumer focussed culture, delivering positive customer outcomes, building consumer confidence in firms, and ensuring firms demonstrate compliance:

- Firms need to go beyond the minimum legal requirements/tick-box compliance/disclosure
- Ensuring appropriate protections as markets develop new ways of distributing financial services
- Ensuring the right business model and proper product oversight is in place
- Boards will be challenged to demonstrate the outcomes being delivered for customers
- CBI will monitor and challenge how firms develop their consumer protection risk frameworks including implementation of performance metrics
- Seek and monitor feedback from customers. CBI examining conduct of business returns from Insurance Sector

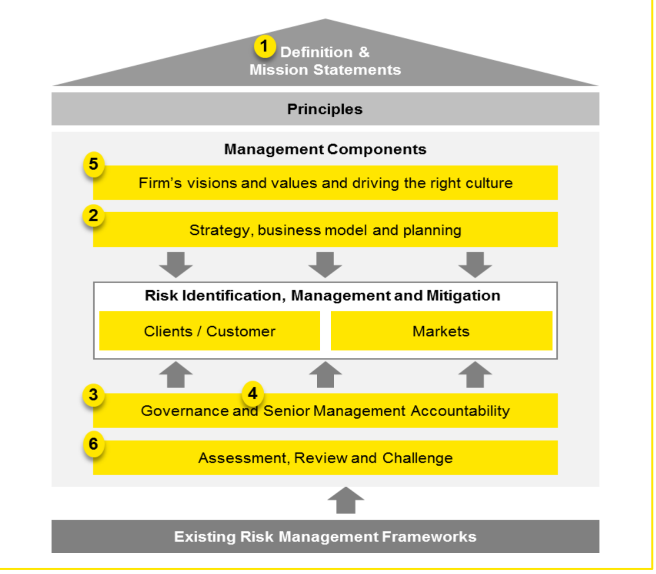
Conduct Risk Frameworks

CBI Challenge: demonstrate effective identification, management and mitigation of Conduct Risks.

Industry Response: development of Conduct Risk frameworks, aligned to the broader risk management framework.

Firms have made varying degrees of progress in developing and embedding a framework with key themes including:

- Conduct Risk definitions and corresponding risk appetite
- Reward structures and incentivisation
- Governance framework and robustness of oversight, including the role of audit and risk committees



- Lessons learned
- Roles and responsibilities
- Metrics to ensure explicit focus
- Assessment of control environment

Conduct Risk Management Information

As part of implementing a Conduct Risk framework, firms are identifying more forward looking Conduct Risk. This includes:

- The use of leading indicators which look at the potential for things to go wrong
- Metrics which measure the types of processes further up the value chain (not just claims and complaints data)
- Focus groups that reflect Conduct Risk and not marketability/appeal of product

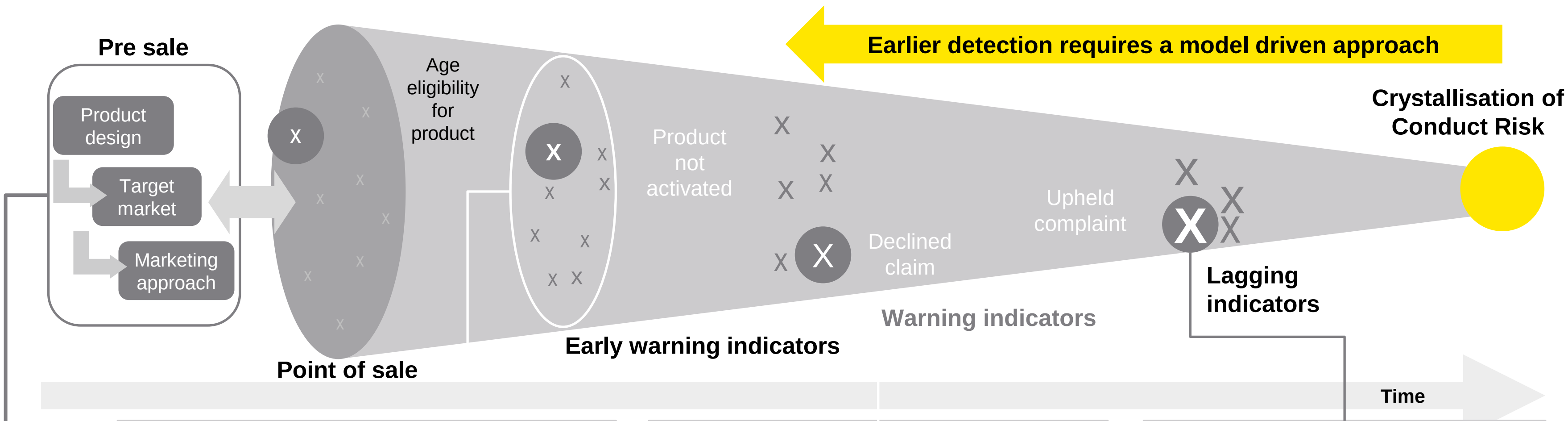
The next table provides an illustration of leading and lagging indicators/measures and how these align across the entire customer lifecycle.

Leading				Point of sale	Lagging			
Product development	**Identifying target markets**	**Marketing**	**Sales incentives**	**Sales process**	**Sales outcome**	**Post sales services**	**Claims**	**Complaint handling**
Customer focus groups	Consumer focus groups	Number of financial promotions rejected	Conflicts of interests	Mystery shopping	Verification	SLAs	Claims decline rates	Defend vs. Uphold
Expected vs. Actual rejection (product approval)	Sales targets vs. how many sold	Reasons for FP rejection	Incentivisation vs. peaks in sales	Staff feedback	Outcomes Testing	Queries raised	Outcomes testing	Reasons for Uphold
Reasons for rejections	Target customer vs. who purchased				Post sale calls	Debt management metrics	Product features claimed against	Outcomes testing
					Activation rates	Attrition/dormant accounts		

Firms need to challenge themselves to create appropriate and relevant conduct of risk MI for reporting to Board and key committees.

Use of Conduct Risk metrics to identify potential detriment sooner

Through the use of enhanced customer analytics, we have developed an approach similar to credit risk, with the potential to deliver major benefits to firms and their customers.



- Preventative action could be implemented through use of enhanced Conduct Risk predictive metrics
- The marketing approach for a particular product can be tailored or particular segments excluded from the planned market
- In an advanced approach, key features of the product design could be developed using the output and experience of Conduct Risk models

- Subtle variations in early warning indicators – not indicative of Conduct Risk in isolation
- Indicative combinations can be picked up through a scorecard based approach
- Ability to detect allows early intervention and mitigation
- Metrics may vary across product and customer types

- Red flag indicators – easier to detect. Presence of, or level of a single metric likely to be a significant indicator of Conduct Risk
- High degree of certainty that detriment has occurred
- Limited time to implement actions to reduce Conduct Risk

Challenges selling through digital means

The FCA views innovation as undoubtedly beneficial for the consumer through bringing increased competition, choice and accessibility, all helping to overcome inertia , but also recognises that as more transactions and services are digitised new risk scenarios will present themselves.

Understanding online behaviour
The FCA advocates the positive use of behaviour economics to 'nudge' online customers into reaching suitable outcomes. With the FCA having upskilled their own staff in this area, there will be an expectation on firms to understand behavioural economics and how to use effectively to produce positive outcomes within their digital sales framework.

The perpetual challenge of keeping up with innovation
As technology advances in other areas such as social media and retail, their will be a consumer expectation and pressure on financial firms to keep up which the FCA has stated 'may outstrip firms' investment, consumer capabilities and regulatory response'

Assessing which products are suitable to execution only
This impatient immediacy of the modern consumer which can be satisfied through fast paced digital transactions,
will make the temptation to distribute increasing products & services this way. The FCA is particularly concerned that without sufficient oversight and controls in place this will lead to a rise in impulsive and ill informed execution only sales. Consideration should be given over more complex products being sold this way such as mortgages and investments.
'*Direct and (seemingly) comparable interfaces and self-service propositions, has in some cases distracted consumers from important product features or risks. This may lead them to make rushed or misguided decisions' – FCA*

Getting execution only sales right
MMR has made an explicit distinction between 'interactive sales' and 'execution only' sales of regulated mortgages with the 'non advised' sales option removed for anything deemed to be 'interactive'. Digital sales will be classified as 'non interactive' and therefore execution only - customers must be clearly notified of the consequences of this and that they will not be able to engage in interactive dialogue during the process. EY experience has found examples where even the most savvy mortgage customers admitted after processing a mortgage online they did not fully understand what they were doing. This highlights the difficulty in building effective digital services that achieve the best possible outcomes.

'Implicit' advice through decision trees
Consumers should understand that they have the same regulatory protections in place when using digital products and services and the appropriateness of these product and service offerings should be the same as in a face-to-face interaction. For example, when building advice models on digital platforms, are you able to clearly demonstrate whether or not customers are receiving advice. *Online advice services cannot rely on falling under generic advice rules by using decision trees as a key element of their processes' - FCA*

Common red flags for risk culture problems

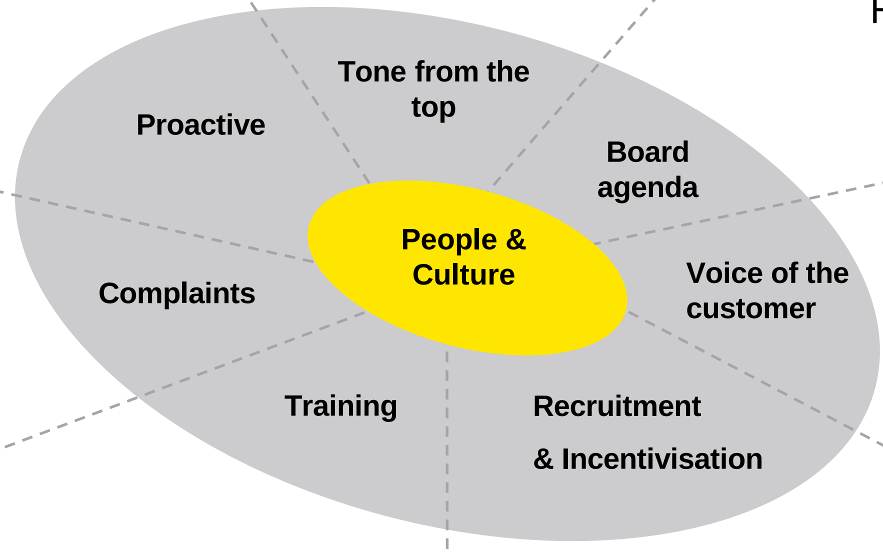
- Risk-taking & reporting lack transparency at board level
- Risk appetite is not embedded in business decision-making
- Behaviour is compliance-focused or control-reliant
- Incentive structures are driving poor behaviours
- The front office lacks risk ownership
- Effective control structures are lacking
- Capacity, complexity & resourcing within risk functions have led to teams being widely stretched

Risk culture failings can result in:

- High staff turnover and loss of corporate knowledge
- A deterioration of enterprise value
- Reputational damage
- Regulatory sanctions
- An erosion of stakeholder trust

Culture in your organisation

- Does the tone from the top cascade through the management chain to the front line?
- Do you deal proactively with issues and learn from mistakes?
- Does the Board devote enough time to ‘Conduct Risk’ as an agenda item?



- Is a robust complaints handling process in place?
- Is there adequate encouragement of, and response to, feedback?
- Are employees appropriately trained?
- How important is good conduct in recruitment, remuneration, and retention?

Thank you

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