MANAGING CONDUCT IN WEALTH MANAGEMENT AND INSURANCE
INSIGHTS - ACTUARIES MANAGING RISK

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FINANCIAL SERVICES

Section 1 | What is conduct risk and how are these issues evolving over time?

Conduct risk has recently emerged as a very broad concept encompassing all kinds of financial firm wrong-doing

> *Conduct risk is any action of an individual [firm] or the [financial] industry that leads to customer detriment or negatively impacts market stability.*

– FSA conduct risk definition (Philip Cooper, 2012)

Typical conduct risk issues within the wealth and insurance space relate to product suitability, costs and performance

Typical conduct risk taxonomy

Risk	Sub-risks	Description	Example issues
Suitability	Suitability	Customer is sold an unsuitable product	• Oversight/management of advisers • Ability to evidence customer needs and ascertain eligibility • Cross coverage sales (e.g. mobile phone insurance, travel insurance etc.)
	Understanding	Customer is sold a product he/she does not fully understand	• Product complexity and (evidencing of) customer understanding • Bundling (e.g. with banking products) • Lack of clarity on cover, claims handling etc.
Premiums and fees	Fair value exchange	Firm is unable to justify the premiums and/or fees charged	• Pricing and ability to evidence a fair value exchange (e.g. for small ticket P&C products with low claims rates)
Product/ performance	Terms and conditions	Product sold does not match T&Cs description	• Various issues around renewal restrictions (e.g. pet insurance) • Use of potentially misleading investment jargon (“defensive”, “balanced”, “absolute return” etc.)
	Performance	Product performance is leading to financial detriment	• Losses in financial investments

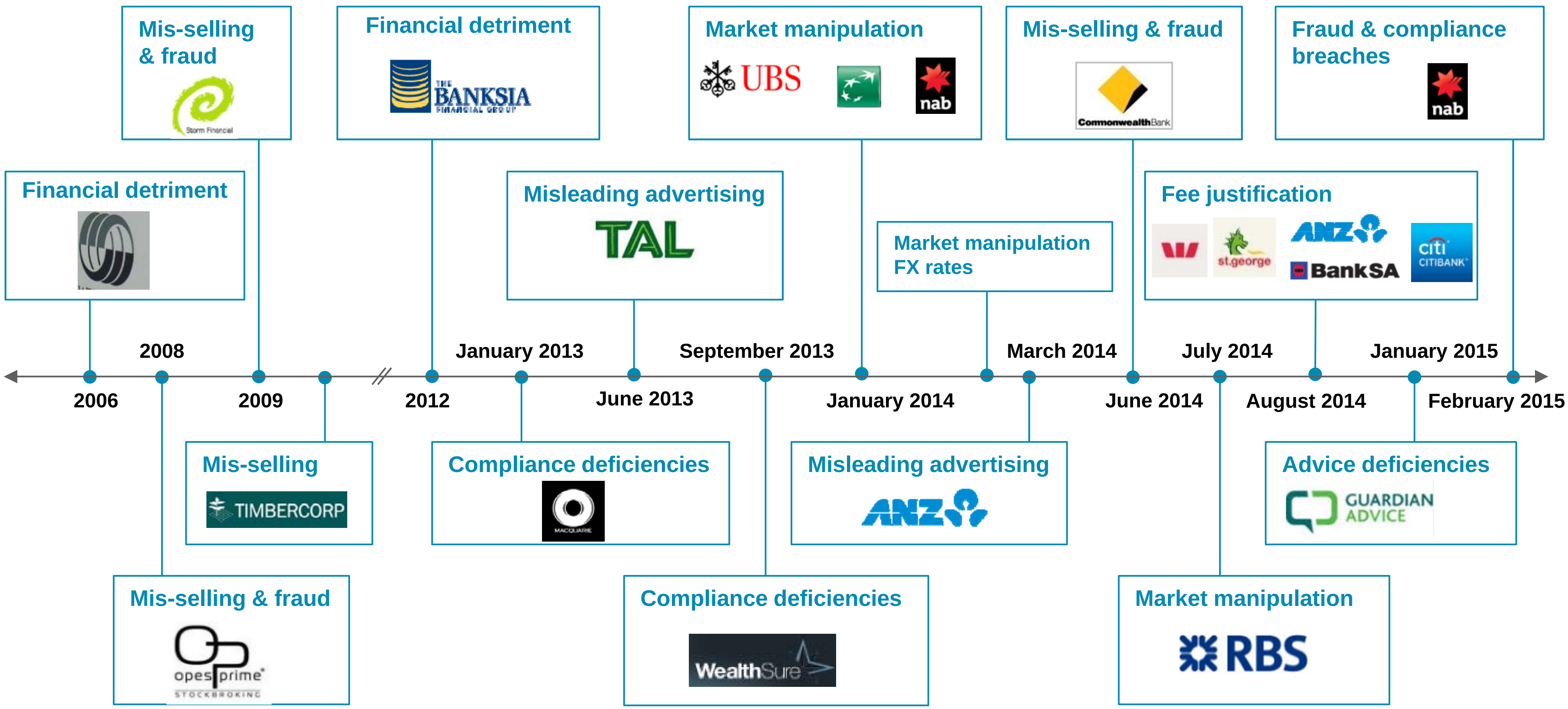
Poor conduct leads to the deterioration of relationships, subpar returns, and increased regulatory burden on institutions

Impact of poor conduct

Relationships	• Increased importance of long-term relationships given new advice models and challenged product economics • Reputation, trust and loyalty among customers can take decades to develop, but moments to destroy
Returns	• Significant fines/legal costs • Dealing with regulatory investigations, litigation, and remediation diverts management attention from value creation
Regulation	• Increasingly restrictive and intrusive regulatory standards imposed in response to misconduct incidents

Conduct risk has emerged as a material source of value destruction

A number of significant conduct issues have emerged in the wealth and broader financial services space in Australia in recent years



There is a need for increased oversight and communication to ensure positive customer and market outcomes

Expected evolution

Regulatory shift	Industry shift	Improved communication
• Continued tightening of regulation • Shift towards greater accountability by financial institutions • Focus on customer outcomes, including avenues for recourse in case of negative outcomes	• Increased need to: – Acknowledge issues and diagnose conduct risk drivers – Explain approach to conduct management – Provide credible commitment to change	• Dialogue between institutions and regulators to ensure that conduct strategies are well communicated, understood and accepted • Proactive public communication by industry and regulator to avoid trial by media

It is increasingly important for the industry to join the debate on conduct regulation

Section 2

How are regulators reacting to conduct risk?

Regulatory oversight of conduct is evolving rapidly across many jurisdictions, with international practice converging on 4 key elements

Four key elements of regulatory practice

Key element		Details
1	**Principles-based approach**	• Increasing emphasis on principles-based approach to complement specific rules • Specific emphasis on: – Culture – Incentives – Internal governance and accountability mechanisms at Board, Executive and Compliance level (with 3 lines of defence model)
2	**Focus areas**	• Specific focus areas are emerging – Across jurisdictions specific themes are emerging: client suitability, customer affordability, new product approval processes, customer complaints handling – Specific hotspots based on individual markets
3	**Soft enforcement**	• Shift to preventative “soft enforcement” to complement mainstream enforcement mechanisms
4	**Resourcing**	• Scaling-up of resource requirements by regulators to deliver on: – More ambitious supervisory agenda – Improved organisational effectiveness – Higher fines

Regulators are responding to misconduct mainly through stricter regulations, heavier penalties and increased surveillance

Typical types of regulatory responses to misconduct to date

Conduct regulations

- Stricter conduct regulations, including:
  - Requirements around improved customer communication
  - Restrictions on product design and pricing
  - Focus on “fair exchange of value”

Misconduct penalties

- Heavier misconduct penalties, including:
  - Increased maximum jail term and fines for market misconduct

Regulatory surveillance

- Increased regulatory surveillance, including:
  - Increased investigative powers
  - Greater resources to enhance conduct supervision (e.g. corporate regulation taskforce)

ASIC has identified conduct as one of four key risks for focus in the recent strategic outlook report

Key risks

Conduct-related

- Gatekeeper conduct in markets
- Gatekeeper conduct in financial services

Innovation-driven complexity

- Retail product design and disclosure
- Product distribution and financial market innovation and complexity

Globalisation

- Cross-border business activities

Expectations gap

Key areas of focus

	Detect	Respond
Gatekeeper conduct in financial services	• **Proactive risk-based surveillance,** targeting – Financial advice firms – Responsible entities operating managed investment schemes • **Assess all breach reports** and reports ‘of misconduct • **Gather hedge fund data**	• **Take enforcement action**, accept enforceable undertakings and issue infringement notices, where appropriate • **Provide guidance** on how the law will be administered

Source: ASIC

A targeted surveillance of life insurance advice conducted by ASIC has identified a range of factors affecting quality of advice

Key factors affecting life insurance advice

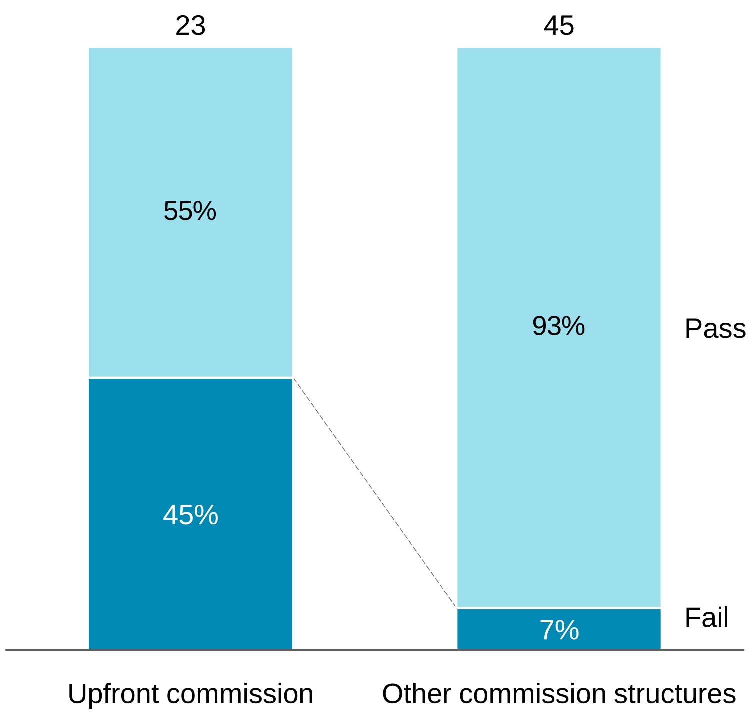
- Adviser incentives
- Inappropriate scaling of advice
- Lack of strategic life insurance advice
- Weak rationales for product replacement advice
- Failure to consider the relationship between life insurance and superannuation

Warning signs of poor advice

- High clawback rates
- High volumes of replacement product advice, product bundling and upselling

Advice rating by commission structure

%



Insurers should work with advisers to address any signs of such factors

Source: ASIC

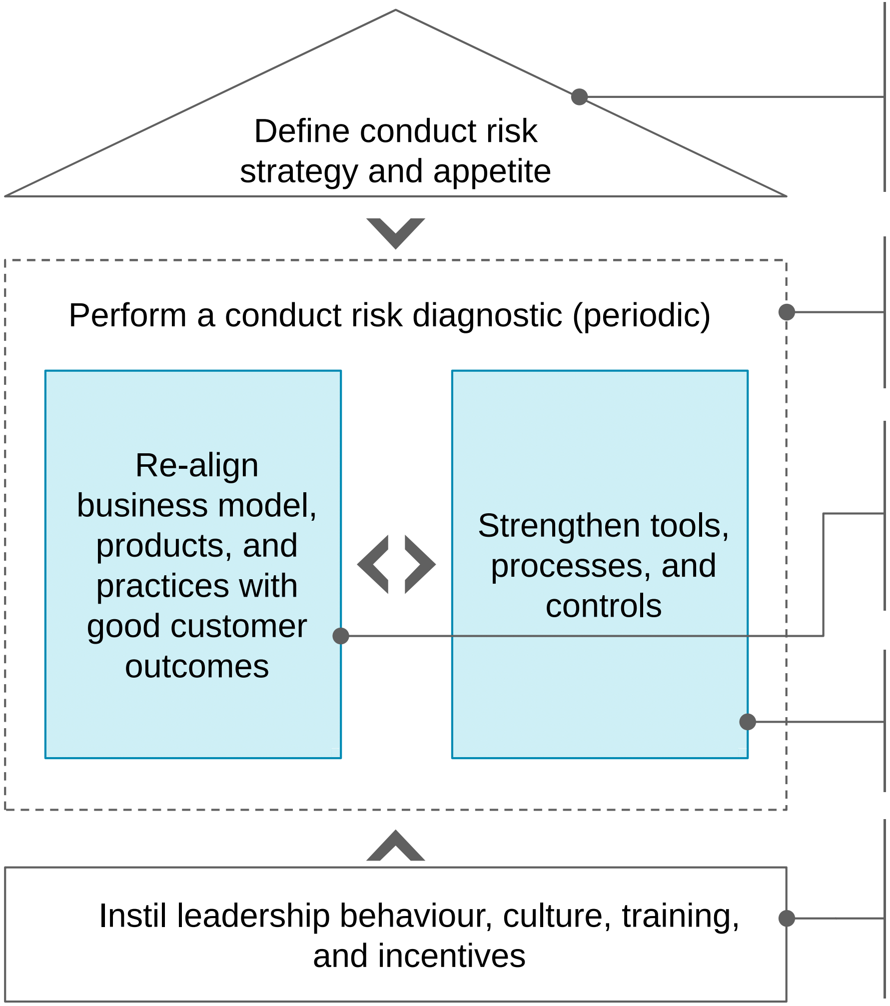
Section 3 | What more can firms do to manage conduct risk?

There are four key emerging risks that are not yet being fully addressed across the industry

1	**Outcomes**	• Following the rules not enough – focus is on whether customers getting good outcomes not insurers’ processes • Defence that “we did nothing wrong because we followed the rules” of little consequence if outcome for customers poor
2	**Value for money**	• Uber-transparency means products under public and regulatory scrutiny to prove value for money • Relying on price disclosure not enough if insufficient benefit underpinning the value or usefulness of the product
3	**Equality**	• More pressure expected from legislators demanding elimination of certain customer groups being disadvantaged • From public policy perspective, pricing making insurance more expensive (or unaffordable) for some customer groups unattractive • More attention will extend to price discrimination between shoppers and non-shoppers or between new and existing customers
4	**Limits on the use of data**	• Insurers need to be sure are happy to defend – in public - their sources and usage of personal data • As amount of personal data being stored grows, regulators more vigilant, and less tolerant, of errors or lapses in capture and control of customers’ data

A strong tone from the top, effective diagnostic techniques and proper alignment of business models are key to managing conduct risk

Five elements of a comprehensive conduct risk management strategy



- Clear relationship between good conduct and business strategy through company values and mission
- Cascading of conduct risk appetite across institution
- Clear ownership and accountability of conduct strategy

- Well structured diagnostic to identify major vulnerabilities
- E.g. “follow-the-money” approach – looking at products/ segments with unusually high returns

- Reduced focus on maximising product sales
- Transformation to customer specialists by focusing on “selling the right product to the right person”
- Not hiding behind the “rule book”

- Review of five major processes, preferably by frontline management: product development, customer segmentation, customer prioritisation, sales, post-sales

- Reinforcement of activities 1–4 through strong tone from the top and well-articulated messages
- Shift of culture through training, incentives and risk-aware hiring practices

Best practice conduct risk management comprises a range of actions

Conduct list – insurance industry "to do" list

✔ Strategy development	✔ Suitability
✔ Risk diagnostic	✔ 3rd party relationships
✔ Risk appetite	✔ Cultural change
✔ Incentives design	✔ Operating model
✔ Performance management	✔ MI development
✔ Complaints management	

☐ Areas where insurers typically require most work

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