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INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS

ISSUES PAPER ON CONDUCT OF BUSINESS RISK AND ITS MANAGEMENT

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About the IAIS

The International Association of Insurance Supervisors (IAIS) is a voluntary membership organization of insurance supervisors and regulators from more than 200 jurisdictions in nearly 140 countries. The mission of the IAIS is to promote effective and globally consistent supervision of the insurance industry in order to develop and maintain fair, safe and stable insurance markets for the benefit and protection of policyholders and to contribute to global financial stability.

Established in 1994, the IAIS is the international standard setting body responsible for developing principles, standards and other supporting material for the supervision of the insurance sector and assisting in their implementation. The IAIS also provides a forum for Members to share their experiences and understanding of insurance supervision and insurance markets.

The IAIS coordinates its work with other international financial policymakers and associations of supervisors or regulators, and assists in shaping financial systems globally. In particular, the IAIS is a member of the Financial Stability Board (FSB), member of the Standards Advisory Council of the International Accounting Standards Board (IASB) and partner in the Access to Insurance Initiative (A2ii). In recognition of its collective expertise, the IAIS also is routinely called upon by the G20 leaders and other international standard setting bodies for input on insurance issues as well as on issues related to the regulation and supervision of the global financial sector.

Issues Papers provide background on particular topics, describe current practices, actual examples or case studies pertaining to a particular topic and/or identify related regulatory and supervisory issues and challenges. Issues Papers are primarily descriptive and not meant to create expectations on how supervisors should implement supervisory material. Issues Papers often form part of the preparatory work for developing standards and may contain recommendations for future work by the IAIS.

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Issues Paper on Conduct of Business Risk and its Management

Contents

1. Background and purpose

1. The IAIS *Application Paper on Approaches to Conduct of Business Supervision* ("the COB Supervision paper")[1] points out that, historically, insurance supervisors have sought to protect policyholder interests mainly by focusing on the financial soundness of individual insurers and, in more recent times, extending this focus to the financial soundness of insurance groups and conglomerates. Although it has long been recognised that supervisory systems should also protect consumers from unfair or abusive business practices, this has typically been regarded as secondary to maintaining financial soundness.

2. However, the impact of poor business conduct has attracted more attention in recent years. Conduct failings can and do occur in, and affect, individual insurance markets. The recent global financial crisis highlighted that poor conduct of business can also give rise to systemic risks. Not only does poor conduct affect individual customers, it can impact whole markets, the reputation of individual insurers and consumer confidence in the sector as a whole.

3. Financial sector supervisors need to ensure that supervisory frameworks adequately address both prudential and conduct of business risks, and also recognise the differences and interlinkages between the two.

4. Prudential and conduct of business supervision pursue a common goal in protecting the interests of customers. Indeed, the connection between consumer protection and financial soundness is made in the IAIS's mission statement: "The mission of the Association is to (a) promote effective and globally consistent supervision of the insurance industry in order to develop and maintain fair, safe and stable insurance markets for the benefit and protection of policyholders; and to (b) contribute to global financial stability."

5. While ICP 8 (Risk Management and Internal Controls) and ICP 16 (Enterprise Risk Management for Solvency Purposes) address the identification and management of risk within an insurer, IAIS literature in general is currently limited in its discussion of conduct of business risks. It could be argued that conduct of business risks are implicitly considered to fall within the references in those ICPs to "operational risk", which requires appropriate risk management (ICP 8) and sufficient capital (ICP 16). However, there is benefit to having more discussion specific to the management and/or mitigation of conduct of business risks.

6. In the aftermath of the financial crisis, supervisors' immediate priorities were to focus on prudential regulatory issues, including strengthening capital. As the concept of conduct of business risk now gathers momentum globally, it is timely that the IAIS considers this form of risk in more detail within the context of supervision of the insurance sector. This is also recognised in the *IAIS Mission and 2015 – 19 Strategic Goals*[2], High Level Goal 2, which recognises the importance of conduct of business supervision alongside prudential supervision. In addition, other international bodies are focusing on conduct of business risks, as evidenced by publications of the Financial Stability Board (FSB), the Organisation for Economic Co-operating and Development (OECD) and others.

7. In describing conduct of business risks and their mitigation, this Issues Paper seeks to contribute to a comprehensive understanding and assessment of a sound risk culture and raise awareness of conduct of business risk, with a primary focus on retail customers. It reflects and highlights ideas on the scope of, and approaches to, conduct of business risk management that IAIS members may wish to consider when implementing ICP 19 on Conduct of Business, ICP 18 on Intermediaries and ICP 9 on Supervisory Review and Reporting. More particularly, the paper considers the sources and impact of conduct of

[1] IAIS *Application Paper on approaches to conduct of business supervision*, paragraph 36.
[2] IAIS *Mission and 2015-19 Strategic Goals*, available at the public website of the IAIS, under "About the IAIS."

business risk and its place within risk management frameworks. It also considers the mitigation of conduct of business risk in terms of both the management of conduct of business risk by the regulated entities themselves and the role that the supervisor can play. In doing so, the paper discusses some of the broader consequences that can come from inadequate management of conduct of business issues, such as harm not only to policyholders but to insurers, intermediaries and the insurance sector as a whole. In this regard, the linkages between conduct of business risk and risks to financial soundness (prudential risk) are considered.

8. Section 1 provides the background for the paper and describes its purpose. Section 2 discusses conduct of business risk and its impact; section 3 outlines the sources of conduct of business risk; section 4 provides a description of conduct of business risk management; section 5 adds considerations on the supervisor's role in monitoring insurers' and intermediaries' conduct of business risk. Finally, concluding remarks are made in section 6.

2. Conduct of business risk and its impact

9. It is useful firstly to consider what – for the purposes of this paper – "conduct of business risk" means. In the COB Supervision paper[3], the point was made that different jurisdictions interpret the scope of conduct of business supervision differently. For example, in some cases conduct of business supervision is seen as part of a broader "market conduct" mandate, which includes supervision of market efficiency and integrity aspects such as disclosures to the financial markets, financial market infrastructures (eg securities or other exchanges), insider trading and market abuse, and related activities. It would follow that in such jurisdictions the understanding of conduct of business risk would therefore also encompass these broader elements. The COB Supervision paper however confined its discussion of conduct of business to matters "primarily concerned with the fair treatment of customers", in line with the language used in ICP 19. This Issues Paper adopts a similar approach. For purposes of this paper, a high-level description of conduct of business risk might therefore read 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."[4]

10. 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. This paper primarily focuses on conduct of business risk to retail customers.

2.1 Linkages between conduct and prudential risk

11. The interaction between conduct of business and prudential risks is a dynamic one. For example, poor management of prudential risk may lead to an insurer or intermediary being under financial pressure, which could increase the risk of poor customer treatment such as unfair pricing, inappropriate "hard selling" sales tactics, or unfair claims handling. Conversely, persistent poor customer outcomes may in turn expose an entity to reputational, legal and regulatory risks that could ultimately threaten its sustainability.

12. The definition above suggests that there are key differences between conduct and prudential risks. These differences will lead to different but complementary approaches to risk management and supervision.

Differences in scope and interaction between prudential and conduct of business risks

13. The first difference is one of scope. Conduct of business risks includes risks to which insurers and intermediaries become exposed as a result of the way in which they conduct their business. Equally, the way in which insurers and intermediaries conduct their business could expose them to prudential risks. All such risks should be assessed holistically. However, while prudential risk management focuses almost entirely on risks to the insurer or intermediary itself, conduct of business risks also cover risks faced by the customers of those insurers or intermediaries.

[3] Paragraph 2.2.1

[4] In accordance with ICP 19, the supervisor sets requirements for the conduct of the business of insurance to ensure that customers are treated fairly both before a contract is entered into and through to the point at which all obligations under a contract has been satisfied. ICP 19 describes the principle of fair treatment of customers as encompassing concepts such as ethical behaviour, acting in good faith and the prohibition of abusive practices.

14. In seeking to ensure financial soundness, insurers may focus on mitigating prudential risks through underwriting and administrative practices that promote profitability and contain costs. If too aggressive, these can compromise the interests of their customers in terms of ensuring that product benefits, terms and conditions, and product servicing deliver fair outcomes for customers.

15. Recognising the interaction between conduct risks and prudential risks over time is of utmost importance for insurers' risk management frameworks.

16. As pointed out in the COB Supervision paper[5], contrary to what happens in the case of prudential risks, conduct of business risks may not constitute immediate or direct threats to an insurer's sustainability and soundness, and consequently may not initially attract the attention of prudential supervisors. Nevertheless conduct of business risks can ultimately lead to prudential concerns.

17. This is why monitoring conduct of business risks may play a significant role in the early detection of issues that could affect the financial strength of an insurer, and provide an important input into prudential supervision.

18. For example, unfair or misleading business practices can be symptoms of insufficient control over distribution channels. They can also be signs of inappropriate governance or ineffective internal controls. Ultimately such issues can trigger financial difficulties where insurers need to reassess existing commitments or redress the mis-selling of products. In the same way, inappropriate claims payment policies can be a means to compensate for otherwise unprofitable products or other financial pressures. By identifying unfair customer outcomes, conduct of business supervisors can help prudential supervisors in anticipating emerging prudential concerns.

Complementary impacts of prudential and conduct of business risks on financial stability

19. The second point of interaction between conduct risks and prudential risks is the different but complementary roles they play in relation to financial stability.

20. The recent global financial crisis highlighted that systemic risks can arise not only through poor financial and capital management, but also in poor conduct of business practices. As part of its work on risk governance, the FSB identified poor business conduct as a source of financial instability, leading to the FSB doing further work in this area[6,].

21. For example, to manage their prudential risks, financial institutions, including insurers, may be tempted to transfer more risks to the customer or accept less risks from them. If conduct of business risks are not appropriately managed, this may lead to the accumulation of risks that customers are not aware of or not able to sustain and this accumulation may in turn have a damaging impact on their trust in the insurance or financial sector.

22. There is, therefore, a direct link between monitoring conduct of business risks and the objective of financial stability. Reducing conduct of business risks and promoting fair conduct of business practices contribute to increase customers' trust that regulated entities operating in insurance markets will treat them fairly. Conduct of business supervision, therefore, contributes to financial stability. Conversely, promoting stability of the financial sector, including prudential supervisory action, can be considered as a way to enhance the protection of customers.

[5] See paragraph 36.

[6] In its guidance on *Supervisory Interaction with Financial Institutions on Risk Culture*, the FSB notes: An environment that promotes integrity should be created across the institution as whole, including focusing on fair outcomes for customers. See also sections 1 and 3.2.

23. Conduct of business supervision addresses the balance between customers and the industry by requiring insurers and intermediaries to consider the best interests of their customers, leading to customer trust and confidence and hence promoting insurance market stability.

24. The interaction between conduct and prudential risks means that addressing these risks through supervision requires appropriate coordination between conduct and prudential supervisors. This is discussed further in section 5.

Risk indicators

25. The differences and links between prudential and conduct of business risks can also be illustrated by the differences and linkages between the indicators used to identify these risks.

26. Assessing prudential risks typically entails close monitoring of indicators such as profit, growth, cost, claims and combined ratios. The development of an insurer's profit and growth, for example, has effects on its capital and solvency. On the other hand, the same indicators can serve as conduct risk indicators (see Annex I on conduct of business risk indicators). Looking through the prudential supervision lens, high profit – provided it appears sustainable - is typically considered beneficial for an insurer's capital and solvency. From a market conduct perspective, it is possible that an insurer may be earning high profits because it is efficiently managed and may offer good value to customers. But high profit (historic and planned) may also be driven at the expense of fair customer outcomes, so may be an indicator of products which offer poor value to customers, or aggressive selling practices or high incentives for inappropriate sales. It is therefore crucial to apply both prudential and conduct considerations to an assessment of financial data.

27. However, to complement the prudential approach, monitoring of conduct of business risks needs to recognise the social and legal context of the market and the nature, scale and complexity of insurers' and intermediaries' businesses from a customer perspective. It is also concerned with ensuring that both the collective interests of customers and the interests and needs of individual customers are appropriately taken into account throughout the product life cycle (ie from product design through to the point at which all obligations under a policy have been fulfilled).

28. Conduct of business risk indicators may therefore comprise a relatively greater proportion of qualitative information than prudential risk indicators. Their focus may also be different and comprise both indicators applied at the level of the individual insurer and indicators aimed at assessing market outcomes more globally. For this purpose, conduct risk indicators may be drawn from internal sources (internal to the insurers or intermediaries) as well as external sources, in order to obtain a picture that is as complete as possible, and to monitor the market in the most holistic way.

2.2 Impacts of a failure to manage conduct of business risk

Customers

29. Failure to adequately manage conduct of business risk has a direct impact on customers. It may lead to customers being sold products they do not need and/or failing to buy the insurance products they do need or being inadequately insured. Also, customers may experience a range of unfair outcomes, including not having their reasonable benefit and service expectations met.

Individual insurers

30. There is link between a conduct of business risk exposure for customers and for insurers or intermediaries. Persistent or materially poor outcomes for customers will lead to adverse impacts for insurers or intermediaries themselves. For example, customer complaints may lead to reputational risks and/or a decline in business. A failure to properly manage conduct of business risk may transform into a legal/regulatory risk, also leading to reputational damage and/or it may affect the financial soundness of the individual insurer or intermediary. Ultimately, the reputation of the industry can suffer.

Example from the Netherlands

In the Netherlands, for example, a financial conglomerate sold term life insurance jointly with mortgages. The life insurance premium was paid at the time of taking out the mortgage, as a lump sum, and was financed via the mortgage. The purpose of the life insurance was to ensure that the mortgage would be paid even if one of the income providers passed away, and premiums were very high. Because the mortgage included buying expenses and tax as well as the life insurance premium in addition to the value of the property, this led to mortgages that were too high in relation to the value of the underlying property. As property prices were rising, this did not cause major problems. However, when interest rates started rising, a large number of customers were unable to service their mortgages. This generated a lot of negative publicity, led to a run on the banking division of the conglomerate and ultimately to a bankruptcy.

Broader adverse impacts

31. Conduct of business risks can emerge more broadly within insurance markets and have market-wide impact in that market, ultimately affecting the financial stability of the market concerned. As noted in the COB Supervision paper, the global financial crisis demonstrated that systemic risks can arise not only through failings in financial and capital management but also from poor conduct of business practices. The indiscriminate marketing and poorly targeted sales of sub-prime mortgage products is an example of how failings in conduct can contribute to systemic financial instability.[7]

Example from Slovenia

In Slovenia, there was a large scale operation by non-licensed insurance intermediaries in the late ‘80s and early ’90s selling life insurance policies issued by non-licensed insurers. The essence of the operation was a pyramid or Ponzi scheme. The main motives of the policyholders for buying insurance were the promise of high returns through future commission. Together with high inflation in the late ‘80s, such sales practices virtually destroyed the life insurance market for several years. Slovenian regulators and the supervisor have resolved the issue with strict licensing requirements; however, the consequences might occasionally still be felt in certain sales practices and in the perception of life insurance by consumers. Moreover, at least one insurer has been denied entry into the Slovenian market until it has resolved the issue of selling non-approved policies.

32. Significant market conduct failures can materially affect the confidence in particular insurance products or the insurance sector as whole. In particular, mis-selling practices where the products are sold on a large scale without proper disclosure to customers who cannot afford them or do not need them may be source of long term mistrust in the insurance industry. For example, in the UK, the mis-selling of payment protection plans had a market-wide impact (see Annex II for details on this example).

[7] See also paragraphs 6 and 19-22.

Example from Zimbabwe[8]

Eco-Life was a partnership between Econet Wireless (the largest mobile network operator in Zimbabwe), First Mutual Life (an insurer in Zimbabwe) and Trustco (a third party technical service provider based in Namibia). Eco-Life reached 20% of the adult population within 7 months of launch, but due to a dispute between two of the non-insurance entities, Trustco and Econet, the scheme was discontinued overnight. In undertaking a survey of the discontinued customers of Eco-Life, 63% ruled out the use of similar products in future, 42% were dissatisfied with insurance and 30% felt there were better ways to protect against future problems than insurance. Considering the product had reached 20% of the adult population, the impact was significant.

[8] This example is also mentioned in the (draft) *Issues Paper on Conduct of Business in Inclusive Insurance*.

3. Sources of conduct risks

33. As discussed in the COB Supervision paper, the sources and indicators of conduct of business risk may differ from those monitored by supervisors focusing on prudential risk. 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, 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 insurer or intermediary's own governance models or business processes can contribute to conduct of business risk

- Economic and environmental factors: These are factors related to the external environment in which an insurer or intermediary conducts its business, but which are typically outside its control.

These factors are expanded on in sections 3.1 to 3.3 below.

3.1 Inherent factors

Inherent nature of insurance products and how they are distributed

34. Unlike typical consumer goods, financial products such as insurance products are intangible. Customers cannot see, touch or taste the product they are purchasing and are therefore unable to immediately assess whether the product meets – or does not meet - their needs or expectations, in the way they would do if they were purchasing a physical asset. This adds to the complexity of insurance transactions from a customer perspective. The need for fair, complete and appropriate product information at point of sale is therefore far greater for financial products than for tangible consumer goods.

35. Related to this, the benefits of insurance products are only realised a considerable time (sometimes many years) after the purchase, when a claim arises or when the customer seeks to access savings or investment benefits. Unless sufficient and appropriate information is provided – and understood – at both the point of sale and at appropriate stages during the life of the product, it is often only at this much later stage that mis-selling, inappropriate advice or product limitations become apparent, resulting in a failure to meet customer benefit expectations. The need for adequate ongoing information to ensure that customer benefit expectations are managed and that insurance products remain suitable over the life of the product is therefore far greater than for many other purchases.

36. One particular inherent feature of insurance products – particularly non-investment insurance products - is that their sales are often "supply driven." As opposed to physical assets or even other financial products (such as banking or investment products) consumers are not *per se* inclined to buy them. Most of the population is to a greater or lesser degree aware that it needs some sort of insurance protection; however, the benefit of insurance is not immediately obvious for the consumer.

Insurers have adopted various distribution strategies to overcome the lack of inherent consumer demand.

37. The most common strategy is to distribute insurance products via intermediaries, and persuade the customer of the need for and benefits of insurance coverage. In most cases, intermediaries approach prospective customers (including visiting them at their own homes or workplaces) with a view to recommending a product rather than relying on the customer to initiate contact. The most common model for remunerating insurance intermediaries for their services is for the insurer to pay them commissions based on number and value of successful sales. Commissions are often coupled with additional incentives to achieve particular sales volumes and/or the setting of minimum sales targets.

38. Within the context of insurance distribution, intermediaries play a very valuable but potentially sensitive role. On the one hand, insurance intermediaries play a pivotal role in addressing the risks faced by customers and ensuring proper insurance coverage. The intermediary also plays an essential role in mitigating the information asymmetry risks discussed below, by placing the customer in the position to make an informed purchase decision and educating the customer on the nature and benefits of insurance.

39. On the other hand, the traditional commission based remuneration model for insurance intermediaries can be a significant source of conduct of business risk. The commission model – designed primarily to reward and incentivise sales - may create misalignment between the interests of the insurer and intermediary on the one hand and the interest of the customer on the other. In some jurisdictions, commission as a form of remuneration is seen as introducing inherent conflicts of interest, and steps have been taken to prohibit or limit the payment of commissions. (See further discussion on *Conflicts of Interest* in section 3.2). Arguments are however also raised that any such interventions should be considered carefully as they may result in limiting consumers' access to advice and under-insurance.

40. Other mechanisms insurers use to address the "supply driven" nature of insurance include direct marketing strategies where insurer representatives make unsolicited calls or visits to potential customers to promote products, and strategies whereby insurance products are sold as add-on products to or "bundled"[9] with other financial or non-financial products – for example sold together with banking or credit products, or marketed through retail shopping outlets together with tangible consumer goods. In the case of direct unsolicited calls, the risk arises that the customer is pressured into concluding a transaction without having adequate opportunity to consider their decision. In the case of bundled products, the risk arises that the customer is likely to be more focused on their primary purchase and not pay sufficient attention to the details of the insurance product being purchased alongside the primary purchase. (See further discussion on the risks of add-on or bundled products in the discussion of *Governance of Product Design* in section 3.3 below).

Information asymmetries

41. A perfect market implies perfect information for all parties involved, for instance regarding price, quality and the customer's needs, risks faced and circumstances. Information asymmetries arise where one party has better information or understanding of that information than the other. This is particularly relevant in regard to information held by customers, insurers and intermediaries respectively in the buying and selling of insurance.

42. Insurers and insurance intermediaries have the advantage of better knowledge of the characteristics of the products they sell and may even have better understanding of the risk profile of customers than the customers themselves. Consumers of insurance products all

[9] The (draft) *Issues Paper on Conduct of Business in Inclusive insurance*, uses the term "bundled" to mean insurance products that combine more than one risk-based insurance cover in one product, for example a term life cover combined with a health cover.

too often do not fully understand the products and services they buy. As a consequence they often do not give the right signals or provide incomplete information to insurers or intermediaries.

43. In the most developed insurance markets, insurance pricing has become extremely refined as insurers utilise big data and a variety of predictive analytical scoring models. The nature and extent of information asymmetry has grown in the insurers' favour with the advent of big data.

44. Financial product and service innovation – including the use of big data - can result in improved competition and more effective and efficient service offerings. However, innovation can also result in greater complexity of products and corresponding risks that products are not adequately understood. In addition to the growing complexity of insurance products, the distribution channels and servicing models for products have become more numerous and of different types. This adds to the complexities that face customers when trying to understand the environment in which they are buying a product and assess the range of products available to them.

45. In view of these complexities, disclosure alone may not be sufficient to address conduct risks arising from asymmetry. In some jurisdictions, supervisors and policy makers have recognised a need to adopt a more interventionist approach and change regulatory frameworks to address the inherent risks of information asymmetry. Such interventions include the setting of explicit product standards for products sold to less financially sophisticated customer groups, and the prohibition or limitation of certain types of distribution models for certain types of products.

46. Enhancing consumers' financial capability has been targeted as an international goal of the G20, leading to the publication of *High-level Principles on National Strategies for Financial Education*[10] that were developed by the OECD International Network on Financial Education (OECD/INFE).

47. Indeed, education plays a major role in enabling consumers to understand the information disclosed to them. Where financial literacy levels are low, the inherent information asymmetry between consumers and industry players is exacerbated, and the risks of exploitation of that asymmetry are increased. In addition, where consumers have low levels of financial literacy, the competitive benefits of innovation may be undermined, as customers may not be in a position to make informed choices. The aftermath of the financial crisis has shown how important financial literacy is, especially in an environment in which products have become more and more complex, with risks transferred to customers, sometimes in an opaque manner and involving an increasing number of stakeholders. Increasing financial capability thus can help to mitigate risks that arise from information asymmetries.

48. The goal of financial literacy is to empower consumers with knowledge that will help their understanding of financial markets and products and so enhance their "market power". There are other approaches to increasing consumer market power as a means of promoting market discipline on insurers and intermediaries, including suitability of disclosure and requirements for and limitations of product design.

49. In order to address the gap in the traditional approach to financial education or literacy and so as not to provide a barrier to people when they need appropriate information, it is important that continued and easy access to all relevant information is available at the time when people have to make financial decisions.

[10] Available at the OECD website.

50. However, due to the inherent complexity of insurance products and the limited time customers can devote to the study of detailed contracts, education cannot be considered as a panacea. Even well-educated customers can face difficulties in understanding risk and product features. Therefore, disclosure and advice are of utmost importance during the underwriting process.

51. In inclusive insurance markets, the fair treatment of customers and providing value to customers often support public policy objectives such as poverty alleviation, food security and improving the health of the population.

Consumer behaviour

52. Even when consumers are fully informed and capable of making a decision, behavioural biases can still lead to suboptimal results[11]. The consumer is not a *homo economicus* who always chooses the product or service that best suits his/her needs. Consumers will not necessarily make decisions that have entirely rational bases; sometimes other factors play a role in the decision, for example culture, intuition and emotion.

53. For many decades, economics relied on models that assumed people chose rationally: with normal capability, people would form accurate expectations about the likelihood of future events, and choose the product that best served their needs by assessing all relevant costs and benefits. The growing literature on behavioural economics shows not only that this is not the case, but also that some errors made by consumers are persistent and predictable. This raises the prospect of insurers and intermediaries designing business models to take advantage of these behaviours, rather than designing products and processes to mitigate risks arising from these behaviours.

54. Behavioural biases can be categorised in one of three ways. First would be “preferences”, such as present bias, where the urge for immediate gratification values the present more highly than the future – an example would be over-borrowing: using a high interest short term loan to buy the latest tablet or mobile phone, without thinking how the loan would be repaid. Second would be “beliefs”, such as over-confidence – for example, an excessive belief in one’s ability to select winning stocks. Third would be “decision making” bias, such as persuasion and social influences – an example would be consumers allowing themselves to be persuaded to trust the sales person because he or she comes across as ‘likeable’ and therefore trustworthy, and thus relying on financial advice because the adviser is likeable, without giving weight to the effect of commission or other economic incentives for the adviser on the advice they receive.

55. While biases affect consumer choices in many different markets, there are several reasons why they are particularly likely to affect decisions in retail financial markets: most consumers find financial products complex; many financial decisions require assessing risk and uncertainty; financial decisions may require making trade-offs between the present and the future; many financial decisions are emotional; and it can be difficult to learn about financial products.

56. This can cause significant problems that financial markets, left to themselves, will not solve. A good example is payment protection insurance (PPI) in the UK (see Annex II) and similar products in other jurisdictions. Insurers were able to earn large profits on PPI products because many buyers fundamentally misunderstood PPI pricing and the limitations to its coverage.

[11] The UK’s Financial Conduct Authority has conducted work in this area. See Occasional Paper No. 1: *Applying behavioural biases at the Financial Conduct Authority*, April 2013.

3.2 Governance and business processes

57. One of the objectives of corporate governance by insurers and intermediaries is to protect the interests of policyholders.[12]

58. A governance framework has culture at its heart; this influences the way in which individuals behave. Where a culture of fair treatment of customers is not embedded within the business objectives and strategies, there is a higher risk that staff and management behaviour or business processes give rise to poor customer outcomes. The culture of an organisation needs to be set from the top (ie the Board and Senior Management).

59. In order to mitigate conduct of business risk, a culture of fair treatment needs to be sufficiently reflected in the governance framework and business objectives and strategies, with sufficient attention paid to ensuring fair customer outcomes in the corresponding policies, procedures, risk management and internal controls. In implementing a governance framework that promotes fair customer outcomes, the following are some of the key factors and areas that will be important:

- the Board and Senior Management are sufficiently involved in and accountable for promoting good business conduct
- policies and procedures on managing conflicts of interests are adequate
- appropriate product design governance or, in the case of intermediaries, appropriate product selection processes, ensure that products are designed and promoted to be suitable to the needs of target markets
- remuneration and incentive policy sufficiently takes into account good customer outcomes
- staff at all appropriate levels are adequately trained in the organisation's commitment to good business conduct and what they need to do to ensure it is achieved
- recruitment, performance management, and disciplinary processes take customer outcomes into account.

60. Where insurers and intermediaries do not embed a culture of fair treatment of customers within their governance frameworks and business processes, there is a higher risk of poor customer outcomes. This message is also emphasised by the FSB, which addresses business conduct as a key element of a sound risk culture[13]. Some of the key sources of risk are considered below.

Governance and risk management frameworks' focus on conduct of business

61. In light of the historic supervisory emphasis on prudential risks, the governance processes of insurers and intermediaries tend to focus on financial aspects to a greater degree than customer facing aspects of the business. Risk management frameworks – including frameworks for internal and external audit and compliance monitoring – tend to focus on financial soundness risks to the entity itself, with less emphasis on risks posed to the insurer's and intermediary's customers (see further discussion in Section 4 below). Related governance processes such as decision-making frameworks and delegations of authority also tend to be based on financial consequences to the entity, rather than the impact on the customer.

[12] See ICP 7 in relation to insurers.

[13] See Section 1 above and FSB: *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture, A Framework for Assessing Risk Culture*, 7 April 2014.

Conflicts of interest

62. Conflicts of interest can create barriers to good conduct, particularly where the insurance seller is in a stronger position than the buyer, for example in view of information asymmetries. Conflicts arise where the insurer or intermediary is subject to competing interests; a number of examples of situations in which these can arise are given in ICP 19.[14] Where personal interests, including incentives, compete with duties of care owed to customers, they can create risks that insurers and intermediaries will not act in customers' best interests.

63. Commissions and other sales incentives have been a particular source of concern in many jurisdictions. Risks increase where remuneration structures do not support fair treatment. Where incentives do not sufficiently take into account good customer outcomes as a factor, this can encourage behaviour by insurance intermediaries or the insurer's sales staff that is not in the best interest of their customers, for example recommending a product that would result in a higher commission or a salary bonus rather than one that best suits the customer's needs, or encouraging a customer to buy a product that they do not need.

64. Intermediary compensation structures which do not align the interests of the insurer and intermediary with the interest of the customer, for example by rewarding sales over long-term retention or suitability of the products, can result in unsuitable sales or unnecessary replacement of life insurance and savings products. Such compensation structures may put intermediaries under pressure to achieve sales results and "push" sales of products that customers might not need or be able to afford. Furthermore, in efforts to ensure a sale, such intermediaries might advise customers to enter into lower priced products which offer lower protection than required.

65. The increased sophistication of some intermediary remuneration models, including contingent commissions, profit sharing arrangements, etc. further exacerbates the potential for conflicts of interest.

66. It is, however, not only the remuneration of insurance intermediaries or sales staff that may entail conflicts of interest. To support fair customer outcomes, it is important that remuneration models across all relevant levels of the organisation do not conflict with customer interests.

67. Factors that may increase conflict of interest risks include:

- performance assessment and incentives being based on financial profitability and/or efficiency/productivity measures at the expense of customer outcome related measures
- lack of alignment between the incentives of senior management and those at lower levels of the organisation
- non-financial incentives, such as performance management, for sales staff being linked to sales targets rather than customer outcomes
- pressure to engage in cross-selling, including "add-on" products
- customer related performance targets being vague or too easily achievable, resulting in less focus on achieving these.

68. Remuneration models are not the only source of conflicts of interest that could result in sub-optimal outcomes for customers. Conflicts of interest can also arise as a result of the way in which the business relationships between insurers, intermediaries and their groups,

[14] See ICP 19.7

or their relationships with other parties, are structured. This is not to suggest that these types of business relationships are necessarily problematic, but that particular risk mitigation measures may be required in these cases. Examples include:

- intra-group relationships where different entities within a group offer different products and services to the same customer base – for example where the group offers insurance, intermediation, and other products and services. This can support convenience and efficiency for customers, but can also lead to bundling of products and services in ways which can inhibit freedom of choice, add layers of cost, and sometimes entail conflicted advice
- shareholding and ownership arrangements can be such that the insurer or intermediary is incentivised (directly or indirectly) to act in the interests of shareholders or owners at the possible expense of customers. In particular, conflicts of interest can arise where an intermediary has an ownership interest in an insurer, or vice versa. Similar risks may arise from profit sharing or joint venture arrangements, particularly where the nature of such relationships and their associated incentives are not transparent or well understood by customers
- outsourcing relationships where, for example, services are outsourced by insurers to intermediaries in exchange for additional remuneration – resulting in intermediaries being incentivised to place business with those insurers where they have an opportunity to earn additional income. This may also create the risk of insurers paying outsourcing fees that are not in fact commensurate with the true cost of the outsourced services, in order to attract sales from the intermediaries concerned.

69. Self-placement practices can be another source of conflicts of interest. Some financial institutions sell financial instruments that they themselves have issued in order to comply with enhanced prudential requirements, to their own customer base. Such practices enable them to raise capital in a cheaper and easier way because of the captive nature of their customer base. This risk may be exacerbated within financial conglomerates when, for example, insurers distribute financial instruments structured by banks in the same group to their customers through unit-linked policies.

70. The use of self-placement by insurers may also put customers at risk. These financial instruments are more likely to absorb losses first. Concerns also arise regarding the extent to which these conflicts are disclosed to or understood by customers.

Self-placement as described by the Joint Committee

To comply with the Solvency II Directive's enhanced requirements, some insurers have used self-placement practices (placing with their clients financial instruments that they, or their group companies, have issued and that are eligible to comply with specific prudential requirements).

The Joint Committee of the three European Supervisory Authorities (ESAs) – comprising the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), and the European Securities and Markets Authority (ESMA) – was used to facilitate cooperation between the ESAs in work on self-placement. The Joint Committee carried out an analysis of the sort of breaches to consumer protection rules that are found when these products are sold. Among other risks the customers can face, are insufficient or misleading information about product characteristics, prices or risks. They may also be exposed to misleading marketing and advertising or unsuitable advice.

In this context, the Joint Committee in July 2014 issued a reminder to credit institutions and insurers about applicable regulatory requirements as regards self-placement.[15]

Governance of product design

71. The design of a product is the very first stage of the product's life. Product design is therefore of paramount importance as poor or inappropriately targeted product design has potential to result in material customer detriment.

72. In the product design and approval process, meeting customer needs and delivering on reasonable customer benefit expectations should be balanced against profitability or sales volume priorities. Some insurance products are sold alongside, or as an add-on to, 'primary products'. This business model may also be referred to as "bundling"[16] of insurance products with other products. These primary products may be financial services – eg home loans or other credit products, banking products, etc. – or they may be non-financial products – eg motor vehicles, mobile phones, furniture or services such as passenger flights. The add-on distribution model has a real impact on customer behaviour and affects the way people make decisions. Customers' attention is mainly on the purchase of the primary product rather than the add-on, leading many to buy add-on products they do not need or understand. Buyers of add-on products are less likely to shop around and less price sensitive. They also have a poor awareness of whether or not they have bought insurance products. This risk is particularly high in relation to credit insurance, where the customer's priority is obtaining credit in order to take out a loan or to acquire an asset such as a property, vehicle or item of furniture on credit, and they pay little heed to whether the insurance product that is "bundled" together with the credit offering is in fact appropriate to their needs.

Example from Australia: Add-on insurance

The Australian Securities and Investments Commission (ASIC) recently obtained significant penalties through court action against a firm providing short term, small amount credit contracts to low income consumers (called 'payday' loans in Australia). While the main focus of ASIC's case was on the irresponsible provision of credit, ASIC also alleged that the add-on consumer credit insurance (CCI) sold with the loans was fundamentally inappropriate. The consumers of such credit generally have a low level of financial literacy, and it was clear that most either did not understand the insurance or know they had purchased insurance with their loan. The majority of the consumers taking out the loans and the associated insurance were unemployed, which meant that they were ineligible to claim on the insurance. The Judge in her decision said that 'I accept ASIC's submission that CCI was unlikely to be of any use to customers for a payday loan and certainly useless for those who were unemployed, a fact that must have been known to the provider…The terms of the CCI were such that the insurance was self-evidently unsuited to the needs of most customers'. The court found that the sale of this insurance was 'unconscionable' under Australian law.

73. Customers' ability to assess options and make choices may be hindered by the fact that there is often insufficient information available about the quality and prices of add-ons, and what information is available is often presented very late. Add-on providers benefit from a clear point-of-sale advantage in comparison with standalone providers, which is reinforced by the way customers respond to the add-on option. There is little pressure on insurers to offer good value, and standalone products do not generally constrain sales of add-ons. Analysis shows that this can lead to poor value, and to prices significantly above cost for

[15] See EIOPA's website.
[16] See footnote 10

many add-on products. Ineffective competition translates into consumers paying too much and receiving poor value when buying products distributed in this way.

74. In addition, the insurance industry is increasingly designing products aimed at purposes beyond mere risk coverage eg investment and money saving. These types of products may be complex, and their investment performance related risks may not easily be perceived by the average customer and may not be aligned to the customer's risk profile.

75. An "one size fits all" approach to product design and/or distribution also poses the risk of poor customer outcomes where the insurer's product design process and distribution model do not take account of the needs of different target customer groups.

76. Where intermediaries are concerned, although they are typically not involved in product design, conduct of business risk arises where intermediaries do not do sufficient due diligence when selecting insurance products or insurers, in order to familiarise themselves with the product features and satisfy themselves that the products are suitable for the customers whom they will advise to purchase them.

Product oversight and governance (POG) – a European initiative

Work on POG was launched by the European Parliament to ensure that consumer protection issues are appropriately addressed in the processes that occur prior to the sale of the product. Product oversight and governance is defined 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. Product oversight and governance is distinct from product approval by regulators in the formal licensing or authorisation sense or regulatory interventions such as 'banning' (ie product intervention).

The Joint Committee of the three European Supervisory Authorities (ESAs) was used to facilitate cooperation between the ESAs in this work. In 2013, the Joint Committee issued high level principles on POG. The Joint Committee set several high level principles that encourage manufacturers to define a target market as well as a distribution channel. Manufacturers are able to limit the distribution to the target market or, where products are sold to customers outside the target market, ask the distributor to justify the sale. In addition, the manufacturer should periodically monitor the performance of the product to ensure that it continues to meet the objectives and interests of the target market as well as review the product, where appropriate, to ensure compliance.

Following the publication of these high level principles, the three ESAs became responsible for issuing guidelines on POG. Since then (in October 2014) EIOPA has published a consultation paper[17].

Underwriting practices

77. Poor underwriting practices could result in increased risk to the insurer. They could also result in customers not being treated fairly as the objective of proper risk assessment and accepting individual risks by charging premiums commensurate with the individual risk profile would also suffer, potentially impacting negatively on the interests of larger groups of customers. In some business models, no or minimal individual underwriting is carried out before policy issue, but insurers rely on standard health declarations and/or cover exclusion clauses to manage their underwriting risk. This practice, sometimes referred to as "underwriting at claim stage" may be appropriate in so-called "group underwriting" models, where a group of lives is insured collectively and individual up front underwriting would unreasonably increase the cost of cover. However, unless sufficient care is taken to ensure that customers fully understand the implications and scope of the declarations and/or

[17] EIOPA, Consultation Paper on the proposal for Guidelines on product oversight & governance arrangements by insurance undertakings, EIOPA-BoS-14/150, 27 October 2014, available at EIOPA's website.

exclusions concerned, this practice can lead to materially unfair outcomes with customers' benefit expectations not being met at the claim stage.

Non-advice selling

78. Where products are sold without advice, there can be an increased risk of poor customer outcomes. Customers often do not adequately understand the features and consequences of products, particularly complex products, and these need to be explained to them in a manner that takes the customer's financial capability levels into account, to avoid misunderstanding and outcomes that do not meet their expectations. In models that do entail advice, the intermediary is typically tasked with providing these explanations.

79. Accordingly, in non-advice distribution models, alternative risk mitigation measures may be appropriate to address this information asymmetry risk. Subject to relevant regulatory requirements, alternative measures may include insurers placing particular focus on the quality and clarity of point of sale product information; insurers electing not to offer certain types of products – such as relatively complex products – through non-advice channels; or insurers offering certain products through non-advice channels only to more sophisticated customers.

Quality of advice

80. Where products – particularly complex products – are sold with poor quality advice, the information asymmetry risks are similar to those arising in non-advice models.

81. Various situations, over and above the conflicts of interest discussed above, may result in inadequate or inappropriate advice being given to the customer, for example:

- sometimes advice is based on insufficient knowledge about the customer or inadequate documentation. Customer information that is gathered at the start of the relationship may be insufficient, not providing the adviser with enough information to understand the customer's circumstances, needs and objectives and attitude to risk.
- processes leading to the provision of advice can sometimes be too formal and apparently in place only to satisfy regulatory requirements – a "tick the box" approach

82. In both advice and non-advice distribution models, a "quantity over quality" approach to disclosure should be avoided, where the customer is provided with large quantities of comprehensive information, without due regard to whether the information is appropriate to the customer's level of financial capability and is in fact understood. Requiring a customer to make a declaration that they understand information provided to them may not be an appropriate safeguard

83. In both distribution models, insurers' and intermediaries' IT systems may not be sufficiently developed or adapted. This can be the case in particular regarding non-advice sales via the Internet, for instance where the questions asked to identify the customer's circumstances creates unfair bias toward particular products or focuses on price to the exclusion of risks, benefits or other suitability criteria.

Knowledge, ability and experience of advisers or sales staff

84. Adequate product training is essential to ensure that advisers and sales staff have sufficient knowledge of the product. Where advisers do not understand the product adequately, this increases the risk and can result in mis-selling. Risk of mis-selling is further mitigated by appropriate experience and qualifications.

85. Intermediaries' and insurers' sales staff can have insufficient knowledge as regards business practices and their own obligation to adhere to consumer protection rules. This may result in them failing to follow the necessary procedures to respect consumers' rights. To be complete, training programs should deal sufficiently and appropriately with business practices and consumer protection issues[18] and ensure that knowledge, including specific product knowledge, remains current and does not become obsolete.

Advertising and product disclosure

86. Advertising is often the catalyst for contact between the customer and the insurer or intermediary. Its main purposes are to attract customers to a product, and to encourage them to purchase it. It is a key element in maintaining and growing the business. Supervisors have long been aware of the risks of inappropriate advertising and marketing practices.

87. There are risks when advertising or other pre-contractual material is not clear, not accurate or misleading, including when the presentation of risks against benefits is not balanced. Risk can also arise where different disclosure formats make insurance product features difficult to compare.

88. This pre-contractual phase is closely linked with the issues of information asymmetry discussed above. Disclosure material that is not designed with the financial capability of the target customer market in mind may fail to achieve its intended purpose.

89. Risk also arises where, after the sale, insufficient ongoing information is provided during the life of the product concerned, and there is failure to take adequate steps to monitor the customer's changing circumstances in order to assess the ongoing suitability of the product.

90. Insurers may view disclosure from a legalistic perspective – did documents provided to a customer disclose all features of the product required to be disclosed? This legalistic perspective is generally less effective than one in which disclosures are drafted with the aim of empowering customers to make well informed purchase decisions whilst also fairly establishing customer expectations about the insurance product.

Key Information Document (KID)

Many new insurance products, particularly life products, are complex, making it difficult for consumers to understand the product characteristics. This has led some supervisors to introduce standardised disclosure documents (sometimes called a "Key Information Document", or "KID"), or to call for such templates to be developed. The European Packaged Retail and Insurance-based Investment Product regulation (PRIIPs) provides for a new disclosure template. A KID contains information such as the key features of the product, its risks, the costs and benefits.[19]

Claims management

91. As important as pre-contractual information, post-sale service has to be carefully considered as it can give rise to risks to insurers and customers. Claims management in

[18] Other parties may also be involved in the distribution of insurance. They may have less skills and training compared to conventionally licensed brokers and agents. See for example section [3.2] of the in the (draft) *Issues Paper on Conduct of Business in Inclusive Insurance*.
[19] More detail on packaged retail and insurance-based investment products can be found on the European Commission website.

particular has a prudential risk component as it can have a key impact on insurers' financial soundness, but fair claims management is also key to managing conduct of business risk.

92. As far as customers are concerned, this part of the contractual relationship is of utmost importance. To be adequately covered in case of a claim is the very aim of buying insurance. Therefore, there are then two main risks of failure to meet customer benefit expectations: not to be covered for the risk or being underinsured.

93. Besides insufficient cover, poor claims administration can in itself be a source of risk for customers. They can suffer for instance from unjustified delays or inadequate explanations provided by insurers or intermediaries in relation to claims decisions, at a time when they are typically in a vulnerable or stressful situation.[20]

94. Claims rejection data can be an early warning to detect deteriorating claims experience, indicating for instance weaknesses in the design of the product value proposition or mis-selling practices.

Outsourced processes[21]

95. Insurers and, to a somewhat lesser extent intermediaries, may outsource certain business process. The potential for conflicts of interest to arise from outsourcing, particularly outsourcing by insurers to intermediaries, has been discussed above. In addition, although outsourcing can be an effective efficiency driver, poorly priced outsourcing models pose the risk of additional costs being unfairly passed on to customers. A further conduct of business risk arising from outsourcing models is where insurers or intermediaries in effect "abdicate" responsibility for fair customer outcomes to the outsourced service provider, without sufficient controls in place to ensure fair customer treatment. This risk arises in particular where the insurer or intermediary does not ensure that it has adequate ongoing access to customer related information in order to enable it to monitor customer outcomes. Inadequate data protection and confidentiality controls within the outsource provider are also a key risk area,

Systems and operational business processes

96. Where an insurer's or intermediary's systems and processes are not adequate to ensure suitable levels of customer service, the risk of unfair customer treatment is increased. Examples include unreasonable obstacles to accessing funds, making claims or complaints, or accessing information. The risk of providing incorrect information and errors or delays in processing service transactions may be a direct consequence of weak operating systems.

3.3 Economic and environmental factors

Market-wide business practices

97. Market-wide business practices, such as prevalent product structures, distribution models, marketing strategies, etc. can have broad impact on a large number of customers. In many cases, supervisors will be aware of common market practices or business models that pose a risk of unfair customer outcomes if adequate governance and control measures are not in place to mitigate these risks. The extent to which a particular insurer or intermediary adopts such practices may therefore be an indicator of the conduct of business risk it poses. Examples are discussed elsewhere in this paper and in Annex II.

[20] As is described in section [3.6] of the (draft) *Issues Paper on Conduct of Business in Inclusive Insurance*, efficient and timely claims management is even more pertinent to inclusive insurance customers as very often the insurance covers the basic needs of existence and income and a further decrease in income or sales of assets to cover expenses need to be avoided.
[21] See ICP 2.13

Economic / environmental factors and the structure of the market

98. The structure of the market and the levels of competition in the market may also be sources of conduct of business risk. For example where competition is fierce, insurers and intermediaries may seek to differentiate their offerings in ways that may pose risk to customers – such as by promoting add-on or “bundled” products or features that may not be necessary to the customer or may introduce hidden cost. Conversely, there are also risks where there is insufficient competition, for example in highly concentrated and/or interconnected markets, where conflict of interest risks are exacerbated.

99. Supervisors and industry participants should be particularly alert to the possibility that market failures (eg due to asymmetric information) may generate broad conduct of business risks that result in 'collective action problems'. A collective action problem may arise when an industry practice (eg inappropriate marketing techniques or remuneration policies) causes consumer detriment, but where it is difficult for an individual insurer to unilaterally change the practice as they may lose market share. Supervisors have a particular role to identify and assist in broader solutions to such market wide conduct of business risks.

100. Market structures and competition levels also pose potential risk to financial inclusion. In a saturated market, there may be an increased tendency to target new markets such as unsophisticated, previously excluded consumers. Care needs to be taken to ensure that aggressive marketing practices do not exploit the vulnerability of such consumers and that products sold are indeed appropriate to their needs. On the other hand, in a developing market with less competition, there is the risk that products may not offer adequate value for money due to lower levels of competition coupled with information asymmetry. In both scenarios, although products may be sold into previously under-served markets, there is a risk of true inclusion not being achieved as the products concerned may not deliver fair customer outcomes.

101. In various segments of financial services there is an increasing tendency to transfer risk to customers. These customers, with or without the support of an intermediary, are required to make financial decisions in order to achieve their goal(s) and fulfil their identified need(s), with products designed in such a way that the risk of poor decisions is borne by the customer. For example, retirement savings and investment products where the customer chooses underlying investment portfolios and benefits are solely dependent on the performance of these chosen portfolios. Within this decision making process, assumptions on often unpredictable economic factors such as future interest or inflation rates often need to be made by ordinary customers.

102. Assumptions are also important from an insurer’s perspective, for instance with regard to longevity risk. Although this is primarily a prudential risk it will ultimately have an impact on customers as well. If assumptions turn out to be wrong, customers have a product that may no longer be sustained and therefore will not fulfil their need. One possible example in this area is long term savings policies or life annuities. Since this product typically has a long term focus, potential detriment could be significant. The greater the levels of economic uncertainty and volatility, the greater the risk inherent in products whose performance is linked to these assumptions.

103. Irrespective of the stage of development of a specific market, economic factors also interact with the demand for financial products by themselves. For instance, a recession can result in over-indebtedness increasing the risk of customers making poor financial product decisions (either to enter into additional debt or to cancel policies and cash in investments inappropriately), as well as the risk of exploitation of these vulnerable customers. On the

other hand, in periods of economic success, where credit may be more readily available and customers may be overly optimistic regarding their financial capability and prospects, the risk of customers making poor financial decisions and being lured into unsustainable products is increased.

Legal/regulatory environment

104. To encourage financial sector development that supports fair customer outcomes, the legal and regulatory environment should provide a framework that enables the development of sustainable and competitive markets, supports customer value-enhancing innovation, facilitates monitoring and enforcement of rules, and ensures consumer protection. Unregulated or inadequately regulated and/or supervised financial services providers significantly increase the risk that customers face fraud, abuse and misconduct.

105. On the one hand, gaps within as well as between regulatory frameworks can lead to regulatory arbitrage. On the other hand, inflexible or too detailed regulation can also give rise to conduct of business risk since this can create a 'tick-box' type of compliance instead of a mind-set focused on fair customer outcomes. Too detailed regulation can also lead to unreasonable barriers to new entrants, and therefore hinder market competition and financial inclusion.

Technology

106. Technological developments reduce the importance of actual physical accessibility of financial service providers. At the same time, technological solutions that create a perception of personal proximity are becoming ever more prevalent. A wider range of financial products and services as well as financial online tools and applications are becoming available. There is also more information on products and services than ever before. New technology enables insurers, intermediaries and other financial service providers to customise products and marketing material, Also, using comparison websites to find an alternative product or switching from one insurance company or other provider to another can be arranged within minutes. However, more opportunities and fewer barriers do not automatically mean better market or customer outcomes and can give rise to conduct of business risks.

107. For instance, comparison websites create risks that consumers select products solely based on price, with insufficient regard to the appropriateness of product features to their needs. In addition, there is a risk that complex products are being sold online or using digital platforms without appropriate advice. In line with the developments from a technological perspective, data is more and more considered as a valuable asset in itself. Financial services become more and more data driven. This growing importance of data leads to risks from a privacy protection perspective as well as from a data security perspective. Sophisticated cyber-attacks lead to customer data being stolen, manipulated or destroyed.

108. These developments pose supervisory and regulatory challenges. Supervisors need to adapt, to foresee potential risks, and to act in a timely and appropriate manner to pre-empt emerging conduct of business risks. The regulatory framework needs to adapt as well, since this framework is based on the current situation and existing supervisory methods.

4. Conduct risk management

109. It is important that risk management frameworks are designed to adequately identify, monitor and mitigate all relevant classes of risk, whether prudential or conduct related[22]. An insurer's risk management system should take into account all reasonably foreseeable and relevant material risks to which the insurer is exposed, at both the level of the specific regulated entity and the broader group where relevant. This includes current and emerging risks.[23] An appropriate risk management framework needs to ensure that all risks posed to or by an insurer are managed holistically, at all stages of the insurance product life cycle, from before a contract is entered into through to the point at which all obligations under the contract have been satisfied. Following a holistic approach means that conduct of business risks are fully integrated into the insurer's risk management.

110. Customer complaints and disputes can be time-consuming and costly. Consumers' loss of confidence may damage an individual insurer or intermediary or ultimately part or the whole of the insurance sector. Furthermore, where insurers and intermediaries do not act with due skill, care and diligence when dealing with customers,[24] non-compliance itself represents a compliance and reputational risk. For these reasons conduct of business risks need appropriate attention within the risk management framework.

111. It is important that risk management is an ongoing process. Risks need to be regularly monitored and assessed, as they change over time. Similarly risk mitigation mechanisms (including relevant policies and procedures, training and competence requirements etc) need to be maintained and subject to appropriate evidence and documentation.

112. Where conduct of business risks are concerned, a holistic risk management framework needs to recognise that insurers may wish to review the current risk frameworks they use to determine if they are appropriate for identifying and managing conduct of business risks. Particularly in jurisdictions where risk management has historically been focused primarily on prudential risks, some changes to the risk management approach are likely to be required.

113. The need to review risk management frameworks to address conduct of business 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 dictate the type of risk mitigation measures applied.

114. For example, to the extent that conduct of business risks are 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 risk that customer interests are addressed at an operational level, without paying due regard to the customer implications of the insurer's or intermediary's broad strategic goals. An exclusively operational focus on customer outcomes may result in an entity focusing its risk mitigation efforts on addressing issues of customer service efficiency and transactional processes, without necessarily addressing customer outcomes when setting strategy, designing products and distribution models, etc.

[22] See ICP 8. Although the ICPs do not specifically address risk management frameworks in relation to intermediaries, and the paragraphs which follow therefore focus mainly on insurers, supervisors may wish to consider the extent to which intermediaries' achievement of the outcomes of ICP 18 and 19 would be strengthened through appropriate risk management frameworks.
[23] See ICP 8.1.
[24] See ICP 19.1.

115. Conduct of business risks may also be viewed under the heading of "reputational" risk. This is understandable as poor customer experience can clearly impact negatively on an insurer's or intermediary's reputation. 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.[25]

116. Another relatively common classification of conduct related risks is to regard them as "legal or regulatory" risks. This is because regulatory frameworks typically impose specific customer protection obligations on insurers and intermediaries, with contraventions of these triggering potential supervisory action or sanctions. Where conduct of business risks are viewed mainly from this perspective, there is potential for a "tick the box" approach to managing these risks, with entities focusing 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.

117. It is not the intention of this paper to propose that insurers and intermediaries should necessarily change the risk classification or risk taxonomies they use in order to accommodate conduct of business risks. Rather, the discussion above is intended to highlight the need for insurers and intermediaries to carefully consider how best to accommodate conduct of business risk in whatever risk management framework they have adopted – and to highlight the fact that traditional frameworks may not always lead to the most effective risk identification and risk mitigation actions.

[25] According to the American Academy of Actuaries, U.S. insurers generally address conduct of business risks though operational risk. The identification and management of operational risks (and different types of operational risk) is frequently performed in conjunction with an insurer's internal audit function. Some insurers consider such risks as part of strategic or reputational risk, which may be separately identified in the taxonomy.

5. Supervisor's role

5.1 Supervisory requirements and approaches

118. The supervisory requirements in respect of conduct of business are addressed in other IAIS literature, primarily ICP 19 (Conduct of Business), ICP 18 (Intermediaries), ICP 8 (Risk Management and Internal Controls) and ICP 9 (Supervisory Review and Reporting). A number of other ICPs introduce risk mitigation measures, including for conduct of business risks, through their requirements, inter alia, in respect of licensing and governance. Also, the COB Supervision paper provides a considerable amount of material on how conduct of business requirements can be addressed through the supervisory process, including in the course of off-site monitoring and on-site inspection.

Key factors for a conduct of business risk-based supervisory framework

119. The supervisory framework needs to provide the supervisor with a holistic view of all risks to which an insurer is exposed, as well as risks posed by the insurer and/or the intermediary, at all stages of the insurance product life cycle. Jurisdictions should have risk-based approaches (used by the supervisor and/or insurers) that are appropriate for identifying and managing conduct of business risks. Supervisors need to take conduct of business risks into account in assessing the 'riskiness' of insurers and intermediaries, including creating conduct of business risk profiles and incorporating conduct of business risks within a risk-based approach.

120. Conduct of business supervision can benefit from a forward-looking approach that seeks to identify and address potential risks at an early stage, before they become significant. This involves making forward-looking judgements regarding the likelihood of conduct of business risks crystallising and the most effective supervisory response to pre-empt customer prejudice[26].

121. Mitigating conduct risk should apply at all stages of supervision – from initial licensing to supervisory review and reporting through to enforcement[27].

Prudential and conduct of business supervision: Complementary approaches

122. As pointed out in the COB Supervision paper, conduct of business supervision requires a different set of knowledge, skills and abilities to prudential supervision, including a strong understanding of topics such as:

- insurance law and regulations
- general consumer protection practices
- insurance business models, products and practices
- best practices and risks related to fair treatment of customers.

123. The requirements and expertise used in prudential supervision provide supervisors with a significant amount of information on insurers' financial health. This information can also be useful to conduct of business supervision.

124. Conversely, conduct of business supervision can play a role in early detection of issues that could affect the financial strength of an insurer, and provide an important input into prudential supervision. For example, aggressive or misleading business practices can be symptoms of insufficient control over distribution channels. They can also be signs of inappropriate governance or ineffective internal controls. Ultimately such issues can trigger

[26] See also ICP 9.2
[27] See also ICP 9.2

financial difficulties where insurers need to reassess existing commitments or redress the mis-selling of products. As discussed earlier, inappropriate remuneration and incentive policies can lead to the selling of products that do not deliver fair outcomes, although the discovery and consequences of mis-selling may only arise in the future.

125. Improving the linkage between conduct of business oversight and prudential oversight will facilitate a holistic evaluation of whether the insurance sector is delivering desired customer outcomes and desired broader market outcomes. The goal of prudential oversight is to minimise the likelihood of an insurer failure. Since such failures are rare, prudential oversight focuses on high level policies and procedures for insurer operation as opposed to focusing on data that evidences customer outcomes. In contrast, in addition to reviewing policies and procedures, conduct of business oversight often involves review of a myriad of day to day business practices, such as sales, claims and complaints processes and data. This information in turn can be used on an aggregated basis to monitor market outcomes and assess market wide conduct of business risks.

126. Corporate governance and risk management oversight, from the prudential regulatory perspective, evaluates insurer processes based on the premise that good processes will produce favourable outcomes for consumers and the market. The problem is that there are not necessarily mechanisms in place to assess whether this linkage is transmitting properly - ie that "good processes" indeed produce good outcomes. Some supervisors have adopted granular market surveillance in a variety of forms to evaluate customer and market outcomes in order to assess the effectiveness of insurer governance and risk management processes. Such detailed conduct of business outcome analyses may be helpful in assisting prudential supervisors, who may otherwise have difficulty differentiating between governance processes that are truly effective and those that are not.

Coordination among insurance supervisors and other authorities

127. In cases where conduct of business supervision and prudential supervision are allocated to different supervisors (for example in so called “Twin Peaks” supervision models), it is important that appropriate co-ordination arrangements are established between the two authorities to ensure a holistic approach to assessing the totality of an insurer or intermediary’s risk profile . However, also in cases where conduct of business and prudential supervision resides within an integrated supervisor, coordination may be required between different departments or staff who may have a different focus. Coordination is also important where the supervision of insurers and intermediaries respectively is allocated to different supervisors (or different departments or staff within the same supervisor), as conduct of business risks may be detected by assessing the nature of the relationships between insurers and intermediaries, and not necessarily from the conduct of each of them when viewed separately.

128. Insurance supervisors may also have to coordinate with non-financial supervisors, such as competition authorities, general consumer protection agencies and telecommunication[28] supervisors.

129. Cooperation on conduct-related matters at international level may also be important, as the market in a jurisdiction can be affected by both conduct and prudential issues in another jurisdiction.

[28] In some inclusive insurance markets extensive use of mobile technology is used to distribute insurance products. See *Application Paper on Regulation and Supervision of Inclusive Insurance Markets*, paragraph 5.15

5.2 Risk identification and monitoring

130. As indicated earlier, conduct of business risk indicators will be different from, or additional to, those used for prudential supervision. This applies not only to risk indicators used by insurers and intermediaries themselves, but also to the risk indicators monitored by the supervisor.

131. Conduct of business supervision should comprise a balance of qualitative and quantitative information. In addition, conduct of business supervision requires sufficient quantitative financial expertise to "follow the money". In order to understand the drivers of culture and behaviour in organisations, it is important to understand drivers of profit and cost.

132. In identifying and monitoring conduct of business risk, supervisors need to take an overall view of conduct of business risk indicators – some examples of which are listed in Annex I. The supervisory approach will go beyond the insurer or intermediary- specific factors and include a review of the broader external risk sources discussed in section 3.3 above. These broader reviews may include macroeconomic analysis, as well as market analysis to understand new market-wide trends and developments (such as new product or distribution strategies). Analysis of relevant market-wide data (such as the types and sources of complaints handled by alternative dispute resolution structures), to identify sector or sub-sector risks, may also be used as a basis for supervisory action. The results from market monitoring and other information sources should provide feedback into the supervisory approach.

133. Supervisors may also take into account thinking from the field of behavioural economics, to assess the risk of poor customer outcomes.

5.3 Communication on conduct of business risk by the supervisor

Publication of forward-looking risk assessments

134. As highlighted in the COB Supervision paper, some supervisors take a forward-looking approach to conduct of business risks 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. The assessment may also include an explicit message concerning the supervisor's expectations of how insurers and intermediaries should engage with and react to the analysis contained in such a risk assessment. Such risk assessments could include both risks arising from the business models and practices of insurers and other financial institutions, as well as risks arising from broader economic, regulatory or other external developments. This assessment should be communicated to industry and the public and may include communication on perceived risks, and supervisory expectations on how the supervisory objectives will be met.

Example from United Kingdom: Risk Outlook

In 2013 and 2014 the UK's Financial Conduct Authority (FCA) has published an annual Risk Outlook. These publications set out the FCA's views on the conduct and prudential landscape for the firms it regulates. It looks at the causes of risks and how these affect consumers, and uses this to prioritise areas of supervisory focus in the future.[29]

135. Proactively highlighting potential risks and areas of concern can encourage insurers and intermediaries to take these into account, and can help to stop the issues from becoming major problems. In addition, where the supervisor has proactively drawn the

[29] See UK FCA's webiste for further information.

industry's attention to potential areas of concern, such as business practices that it has identified as potentially leading to poor customer outcomes this may, subject to the regulatory framework in the jurisdiction concerned, strengthen the supervisor's hand if subsequent enforcement action becomes necessary. Where the supervisor's concerns have been clearly signalled, an insurer or intermediary who has not taken account of these concerns and has persisted with the business practices concerned is less likely to be able to defend its actions and challenge the supervisor's intervention if those practices do in fact result in poor outcomes.

Supervisory expectations

136. Supervisors communicate their expectations to industry on conduct of business practices through a variety of means ranging from formal to informal approaches. This can often involve issuing forms of guidance that may be binding, non-binding guidance, or binding but not necessarily subject to the same enforcement processes as explicit rules-based requirements. Guidance is a very useful tool for conduct supervisors to try to influence industry behaviour and to explain expectations regarding rules that are not as quantitative as prudential rules. Examples include:

- "Dear CEO" letters
- information letters
- formal guidance (eg in the form of directives, official notices, circulars)
- recommendations or best practices on how to address specific topics (eg claims or complaints handling).

Such guidance, even where it is non-binding, can be a useful tool for avoiding disputes as to the supervisor's expectations in the event that formal enforcement action is required, particularly in the case of principles-based requirements.

137. Other mechanisms for communication on supervisory expectations include:

- meetings with management
- on-site inspections, including follow-up meetings and communications
- newsletters
- events hosted by the supervisor or industry, professional or consumer associations events.

Example from France: Initiative to influence corporate governance

In France, insurance companies must fulfil on-going reporting requirements on their business practices that include completing an annual "Questionnaire on business practices". This questionnaire helps insurers to better understand the French Prudential Supervision and Resolution Authority (ACPR)'s expectations on consumer protection matters and to reflect consumer protection requirements within their internal control systems.

The questionnaire covers insurers' procedures and processes on various issues (such as conflicts of interest and remuneration, claims and complaints).

It is based on a self-assessment, and as such provides an occasion for insurers to assess their compliance with business practices rules. Moreover, it offers an opportunity for insurers to examine their corporate culture regarding consumer protection.

Public disclosure by the supervisor

138. Some supervisors publish conduct-related information that can help to mitigate risks to consumers. Such information might include:

- warnings (eg in relation to insurers or intermediaries operating without a licence, suspicions of fraud or other financial crime, potential abusive selling practices)
- supervisory action taken (including enforcement action)
- general information related to financial services products and their distribution that seeks to enhance consumer awareness
- data on individual insurers' performance in relation to appropriate conduct indicators or benchmarks – such as complaints or claims related data - that can act as a deterrent to unfair customer treatment[30].

Example from France: Communication with consumers and industry

Communication with consumers

The ACPR operates a common gateway, together with the French financial markets regulator (AMF) and the Banque de France that provides information and guidance to consumers. Under the name of "Assurance Banque Epargne Info Service" (ABE IS), it comprises a website (www.abe-infoservice.fr) and a helpline that provides general information about financial products, contracts and services, and on procedures for dealing with disputes. The website is also intended to warn the public where poor conduct practices have been identified in particular institutions. The ACPR can also issue warnings to the public directly.

Communication with industry

The ACPR is able to issue good practices recommendations to explain how the Authority expects the industry to apply the law and regulatory requirements in practice. These soft law instruments can be an efficient tool to reduce conduct of business risks on a market-wide scale.

Additional means of communication used by the ACPR include things such as its bimonthly publication (La Revue de l'ACPR), and its annual conference.

Example from the United States: Consumer Information and Education

The National Association of Insurance Commissioners (NAIC) provides a variety of public information useful for consumers. Information and tools that U.S. state insurance supervisors have found helpful to make available to consumers include:

- the NAIC's Consumer Information Source (CIS) which provides key information about insurers consumers can use (for example, before purchasing insurance), including closed insurance complaints, licensing information and key financial data.
- INSURE U - Get Smart About Insurance, which is a public education program created to assist consumers with information about insurance issues. INSURE U is designed to help insurance consumers as their lives and needs change, and to educate them about how to avoid being scammed. Since its 2006 launch, INSURE U has featured public service announcements (PSA), consumer alerts, news releases, mobile apps and games, along with integrated social media campaigns, in order to help consumers understand difficult topics.

[30] Some supervisors require insurers and intermediaries themselves to publish such data.

6. Conclusion

139. This Issues Paper demonstrates that prudential and conduct of business risks are closely linked but also differ in important ways and need to be managed, mitigated and supervised in a holistic manner.

140. The Issues Paper provides a number of key messages:

- Impact of Conduct of Business Risks
  - conduct of business risks can generate major consumer detriment, and as a result also produce significant impacts on consumer trust and industry reputation
  - the recent financial crisis has also highlighted that poor conduct of business can give rise to systemic risks
- Sources of conduct of business risks
  - conduct of business risk can arise from multiple sources, including factors inherent to insurance markets, the insurer's or intermediary's governance and business processes, and broader economic and environmental factors
  - conduct of business risk includes risks arising from poor business conduct to which insurers, intermediaries and the insurance sector itself are exposed, but importantly also risks to which insurers and intermediaries expose their customers
- Managing conduct of business risks – issues for supervisors
  - the supervisory framework needs to provide the supervisor with a holistic view of all risks to which an insurer or intermediary is exposed, as well as risks posed by them
  - conduct of business oversight often involves review of day to day business practices such as sales, claims and complaints processes and related data
  - supervisors have a role to play in communicating conduct of business risks and their expectations, to both consumers and the industry
- Managing conduct of business risks – issues for industry
  - conduct of business risk, and all its components and sources, needs to be considered within the overall risk framework of, and risk management by, insurers and intermediaries
  - in order to mitigate conduct of business risk, insurers and intermediaries should ensure that they have a governance framework that supports fair customer outcomes
- Links between prudential risk and conduct of business risk
  - there are key differences between conduct of business and prudential risks that require different and complementary approaches to risk management and supervision
  - conduct of business supervision goes beyond prudential supervision as it not only considers the risks transferred to the insurer, but also the risks remaining at customer level or in some cases transferred to the customer

- conduct of business risk indicators differ from - but may complement - prudential risk indicators, and may be used to assess risks to customer and market outcomes at both individual entity level and broader market-wide level
- where conduct of business supervision and prudential supervision are allocated to different supervisors, nationally or internationally, or to different departments within an integrated supervisor, it is important that appropriate co-ordination arrangements are established.

Annex I

Conduct of business risk indicators

This Annex provides examples of issues or focus areas that insurance supervisors may wish to consider using as indicators of potential conduct of business risk. It is by no means a complete list, and supervisors should develop an appropriate set of indicators that are suitable to the insurance markets in their jurisdictions and to the individual insurer or intermediary concerned. Jurisdiction-specific issues, such as the relevant legal system and culture, also need to be considered.

In most cases, particular risk indicators should not be considered in isolation but should be viewed in combination with other indicators – or other known information about the insurer or intermediary's business – before forming a view on the existence or extent of conduct of business risk exposure.

The risk indicators in this Annex are categorised in line with the categorisation of sources of risk set out in Section 3 of this Issues Paper, namely:

- *Indicators of inherent risks:* These indicators may assist supervisors in monitoring conduct of business risk arising from factors that are inherent in the nature of insurance business and, in many cases, inherent in the nature of financial service provision more broadly. In particular, these indicators may be used to monitor risks related to information asymmetry.
- *Indicators of risks arising from an insurer or intermediary's governance and business processes:* These indicators could be used to identify aspects of the insurer or intermediary's own governance models or business processes that can contribute to conduct of business risk. In particular, they may be helpful in assessing the extent to which fair customer treatment is embedded in the corporate culture and the extent to which governance and business processes promote fair customer outcomes.
- *Indicators of risks arising from economic and environmental factors:* These are indicators of risks arising from the external environment in which an insurer or intermediary conducts its business. Although these matters are typically outside the entity's control, supervisors will wish to monitor the extent to which insurers or intermediaries they supervise are exposed to these types of risks.

1. *Indicators of inherent risks*	
Indicator	**Potential implication**
1.1. Vulnerability of customer base	• An insurer or intermediary whose business model targets customers in low income, unsophisticated segments or with relatively low financial capability, may be expected to take more extensive steps to mitigate information asymmetry risks than insurers or intermediaries operating in less vulnerable customer segments • Where an insurer or intermediary serves customers across a range of segments with different levels of financial capability, the range of products, distribution channels and customer service processes may need to be adequately differentiated to suit the needs and capability of the different customer segments.
1.2. Complexity of products, including degree of risk transfer	• Insurers or intermediaries offering relatively complex products, may pose greater information asymmetry risks than those offering simpler products • The level of financial asymmetry risk arising from complex products is potentially increased where such products are sold to less sophisticated customer groups.
1.3. Type of distribution model	• An insurer's chosen distribution model may either increase or mitigate the risks of information asymmetry – taking into account the complexity of products and / or the vulnerability of the customer base • Controls an insurer has in place – for example quality and suitability of product disclosures, controls over quality of advice, availability of "cooling off" periods, etc. – may indicate mitigation of any risks arising from the type of distribution model used.
1.4. Use of "big data"	• Where insurers or intermediaries make use of sophisticated "big data" analytical tools in their marketing and other business strategies, such tools may be used to unfairly take advantage of behavioural biases (such as applying less favourable charges to customers who are identified as less likely to complain or switch products) • Information privacy issues may also arise in relation to the use of customer specific data.

1.5. Quality of initial and ongoing disclosure	• The quality of disclosure (eg accuracy and clarity of content, target market suitability, timing and frequency) may indicate information asymmetry risk • Initial and ongoing disclosure throughout the life of a product – either at regular intervals and / or on the happening of specific events – may indicate whether customer expectations are being met • Analysis of disclosures or customer complaints and feedback may identify ineffective, unsuitable or unclear communications or disclosures that do not take into account customer capability and product complexity.
2. Indicators of risks arising from governance and business processes	
Indicator	**Potential implication**
2.1. Extent to which customer interests are reflected in strategy and objectives	• Insurers' and intermediaries' strategies and business objectives may indicate how customer interests and impacts have been taken into account, including how those interests are balanced against other strategic objectives and stakeholder interests where relevant • Explicit corporate values, ethics or culture statements or documented business policies that include a commitment to fair customer treatment may also indicate a positive conduct of business culture. Such statements and policies should be supported and monitored by effective governance frameworks and controls.
2.2. Allocation of responsibility for good business conduct	• Where responsibility for specific decisions or processes affecting customers or responsibility for specific customer outcomes, is explicitly allocated to identified members of staff or management, this may indicate a commitment to good business conduct and thus reduced conduct of business risk.
2.3. Extent of alignment between customer interests and remuneration / incentives / performance management of staff and management	• Having policies in place to align staff and management behaviour with customer interests, may more likely indicate effective management of conduct of business risk than those where such alignment is lacking; such policies may include recruitment, remuneration, incentive and reward, performance management and disciplinary policies • Whether policies are applied at all appropriate organisational levels, including the most senior levels of management and where appropriate particular members of the Board or Board committees, may indicate the degree of alignment within an insurer or intermediary • An assessment of the effectiveness of the above policies in mitigating conduct of business risk may identify areas where there is a potential misalignment with customer interests.

2.4. Levels of staff training on conduct of business issues	• Levels and forms of general training on conduct related policies, risks and objectives or job-specific training on specific business conduct related systems or processes may indicate the extent to which relevant staff of an insurer or intermediary has been trained on conduct of business issues.
2.5. Approach to conduct of business in risk management framework	• The extent to which conduct of business elements are addressed in its system of risk management framework may indicate assess the effectiveness of an insurer or intermediary's approach to conduct of business risk management • Relevant issues could include: The extent of the Board and Senior Management's awareness of conduct of business risks to which the entity and its customers are exposed; the extent to which the risk management function and other relevant control functions (such as compliance and internal audit) take conduct of business related risks into account in their processes; whether or how conduct of business related risks are captured in the entity's risk taxonomy or risk categorisation model; the indicators and measures used to identify and manage conduct of business related risks; and the quality and level of management reporting on conduct of business related risks.
2.6. Group structure (including intra-group relationships, ownership structures, self-placements)	• The complexity of an insurer or intermediary's group structure may increase the level of conduct of business risk to which it and its customers is exposed • Relevant issues could include: Potential conflicts of interest where multiple entities in the group serve the same customers or "bundle" their products and services (for example insurers, intermediaries, banks, investment managers); the adequacy of outsourcing controls where activities are outsourced across group entities; information privacy issues where customer information is shared across the group; potentially conflicted remuneration or incentive structures (including profit sharing structures) at group level; self-placement of insurance risks within the group; potentially misleading promotional information where intra-group relationships may not be adequately disclosed.
2.7. Quality of conflict of interest management	• Insurers or intermediaries with explicit conflict of interest management policies, supported by appropriate governance and control mechanisms, may be better positioned to manage conduct of business risks arising from such conflicts than those where such policies are lacking.
2.8. Quality of controls in outsourcing arrangements	• Insurers or intermediaries with explicit outsourcing policies, supported by appropriate governance and control mechanisms, may be better positioned to manage conduct of business risks arising from outsourcing arrangements than those where such policies are lacking.
2.9. Product design / selection processes	• In the case of insurers, product design processes may be the source of conduct of business risk relating to product suitability, such as whether products are suitable to the needs of target customer groups

	• Conduct of business risk may be mitigated where the insurer has processes in place to identify product sales outside of the intended target market and take appropriate action to mitigate the risk of mis-selling. • In the case of intermediaries, the product or product supplier selection process could indicate whether such selection processes take account of the suitability of the products for the intermediary's customer base.
2.10. Use of "bundled" or add-on products	• Where "bundling" of products or selling products as "add-on" benefits to other products (for example, credit insurance sold together with a credit product, or warranties sold together with motor insurance) forms part of an insurer or intermediary's business, processes to ensure that the customer fully understands the existence, features, costs, risks and suitability of the bundled or add-on benefit are important to mitigate conduct of business risk in these models.
2.11. Intermediary remuneration / incentivisation model	Particular focus areas to identify potential conflicts of interest in relation to intermediary remuneration and incentive models could include: • Actual levels of commission or other remuneration paid, in comparison to comparable products or product providers • The extent to which remuneration is based solely on number of sales and / or premium size, or whether the remuneration is also dependent on measures such as quality of compliance with fair treatment requirements, product retention, etc. • Whether different products offer different types of incentives or remuneration levels – in which case it may be useful to monitor the extent to which sales are biased to higher earning products • The availability of additional volume based incentives or rewards over and above commissions • The extent to which remuneration is paid up front and if so, the extent to which this may be influencing policy replacements or "churn" or may be dis-incentivising ongoing customer advice or service • The existence of specific minimum sales or production targets, and the consequences of failure to meet these • The extent to which management remuneration or incentives are linked to intermediary sales volumes. In cases where the above practices are prevalent, greater attention may be focused on the effectiveness of controls in place to manage and mitigate conflicts of interest and mis-selling risks.
2.12. Advice quality controls	The controls in place to monitor the quality of advice provided by the agents or representatives of insurers or intermediaries may affect the risk of providing unsuitable advice. Relevant issues to take into account in assessing the effectiveness of advice controls include: • Quality, extent and frequency of training provided to advisers

	• Processes to monitor advice in specific cases, such as checking of customer case files or sitting in on customer appointments • Extent to which less experienced advisers are required to operate under supervision • Processes used by the insurer or intermediary for monitoring data on sales volumes, product mix, lapses or surrenders, claims, complaints or other customer activities at individual adviser level to identify potential poor customer outcomes.
2.13. Profitability and expense management, including for particular lines of business	• The underlying causes of high profits may indicate whether these are aligned with positive customer outcomes or whether there is a risk that profits are being earned at the expense of fair customer treatment. For example, where high profit margins are a function of unusually high charges or unusually low claims ratios, this could indicate conduct of business risk • Comparing the relative profitability of different lines of business or product types with sales volumes of such products may indicate potentially biased promotion of more profitable products • Conversely, declining profitability – over and above any prudential risks this may trigger – may also increase the risk that the insurer or intermediary concerned may lower its service standards or increase its claim rejection rates to boost profitability • Significant cost cuts may increase the risk of poor service delivery • Rapid growth in the scale of the business may be an indicator of whether the insurer or intermediary's systems and operations are adequately equipped to keep pace with increasing sales or customer volumes • Monitoring which elements of the business generate the highest profits or are allocated a proportionally greater share of expenses, or material changes in the allocation of budgets (ie "following the money"), may help in identifying the strategic priorities of the insurer or intermediary, and determining whether these are consistent with a culture of fair customer treatment.
2.14. Data on lapses, surrenders, policy replacements ("churn") and other contract changes	• Higher than expected lapses or surrenders may be indicators of various conduct of business risks, including product design that does not meet customer expectations; potential mis-selling; or customer affordability challenges • High volumes of early lapses or surrenders, in particular, may indicate potential mis-selling • Where a high proportion of lapses or surrenders are as a result of product replacement, this could indicate inappropriate product design on the part of the initial insurer, but could also indicate conflicted, incentive driven advice on the part of the intermediary concerned (particularly where remuneration is up front at sale stage) • High replacement volumes at individual adviser level, particularly where the same adviser has sold both the original policy and the new one, could further highlight potential incentive driven mis-selling

	• High replacement volumes in favour of a particular insurer could simply be attributable to it offering more competitive, better value products; but could also pose risk that the insurer is adopting particularly aggressive marketing practices, or offering inappropriate incentives to intermediaries and / or customers • Trends in relation to other types of contractual changes could also highlight conduct of business risks. For example, relatively high volumes of premium reduction requests could indicate similar risks to those indicated by high lapse or surrender volumes • Frequent requests to change underlying investment portfolios on savings or investment policies may be cause for concern regarding inappropriate investment related advice.
2.15. Underwriting approach	• Models which entail underwriting of risk across a group of insured lives rather than individual underwriting support cost efficiency and inclusion for certain target markets or types of cover. They may however also pose risks of unsuitability for some members of a group (particularly as such models often do not cater for individual advice) or may result in a lack of benefit flexibility and substitutability, prompting a need for suitable risk mitigation measures • Models where intermediaries share in underwriting profits of the lines of business they promote may also give rise to conflicts of interest which may require managing.

2.16. Claims data and processes	Various types of claims related data may provide insight into the extent to which customer benefit expectations are being met or in relation to the fairness of an insurer's claims processes. Relevant issues could include: • Number and value of rejected claims, including reasons for rejections. Unusually high rejection rates could indicate mis-selling, inadequate disclosure, unfair claims assessment practices, or ineffective underwriting • Number, cause and value of claims related complaints and claims resulting in escalations to alternative dispute resolution forums or litigation. High volumes in this regard, in addition to the risks associated with high rejection rates, could indicate poor communication regarding claims decisions and poor service at claim stage • Number, age and value of outstanding claims. This information provides insight into the efficiency of the claims handling process • Claims ratios (i.e. levels of claims relative to premiums). Unusually low claims ratios may be attributable to a high volume of rejected claims, which may indicate mis-selling or inadequate disclosure; or may be attributable to higher than usual premiums, which may indicate unfair pricing and poor value for money • Loss ratio information identifies insurers with more claims than the norm. Significant deviations from the norm could indicate financial stress if the loss ratio is unusually high; or highlight potential concerns about claims handling or underwriting practices, if the loss ratio is unusually low • Monitoring the above types of claims data at individual product level or at intermediary level may provide additional insight into potential risks of mis-selling or product shortcomings • Levels of claim provisions, compared to incurred losses. Fluctuations in provisions can occur for a number of reasons, some of which might signal conduct of business risks. A spike in provisions without a corresponding change in claims paid warrants investigation. Conduct of business risk relating to unfair claims practices is mitigated where effective controls are in place to ensure the fairness, efficiency and transparency of the claims processes. Positive indicators in this regard could include: • A process to ensure that claims are assessed not only from a legal contractual perspective but also taking into account fairness considerations and the customer's reasonable benefit expectations • Clear and timely communication processes in regard to the progress of a claim, claim related decisions, and available complaint or dispute resolution channels • A process to identify and settle unclaimed benefits • In the case of intermediaries, processes to provide support to claimants in relation to submitting claims and to ensure customers understand the level of support the intermediary will provide.

2.17. Complaints data and processes	Effective analysis of complaints related data provides insight into a wide range of potential conduct of business risks. Complaint information can serve as an early warning system to detect such risks (including potential risk mitigation problems) and to provide a basis for further conduct of business review. Relevant issues could include: • Overall complaint volumes, split into suitable categories to enable meaningful analysis; examples of categories include grouping complaints per: cause of complaint; product type; distribution channel; department / business area; customer type; value of complaint; or combinations of these categories • Number of rejected complaints, including reasons for rejections. Even where complaints are rejected because they are considered invalid or not justified, high volumes of such rejections could indicate customer misunderstanding of products or processes, highlighting a need for improved disclosure and / or training of staff or intermediaries • Number and cause of complaints that are escalated internally (where applicable) or to alternative dispute resolution forums or litigation (or the supervisor in some cases). This measure should also include the proportion of such complaints where the original decision is upheld or overturned. High escalation volumes could indicate poor communication regarding complaint decisions or poor service at complaint stage. High rates of overturned complaints could indicate that the entity is not paying sufficient attention to addressing the underlying causes of the initial complaints, or could indicate a mis-interpretation of conduct requirements • Complaint resolution rates and timeframes, including number and age of outstanding complaints. This information provides insight into the efficiency of the complaints handling process • Goodwill or "ex gratia" payments made in settlement of complaints (including but not limited to claims related disputes). A high volume of this type of settlement payment could be indicative of an insurer or intermediary's reluctance to admit responsibility for unfair business practices • Monitoring the above types of complaints data at intermediary level may provide additional insight into potential risks of mis-selling risks. Conduct of business risk relating to unfair complaints handling practices may be mitigated where effective controls are in place to ensure the fairness, efficiency and transparency of the complaints process. Positive indicators in this regard could include, where appropriate: • Processes to ensure that the complaints management function is adequately resourced, comprises suitably trained staff and is sufficiently independent from other parts of the business to enable objective complaint assessment • Processes to ensure that the complaints mechanism is accessible, bearing in mind the customer market/s concerned • An effective internal escalation and / or review process for complex or unresolved complaints. An assessment of the effectiveness of such a process could take into account how frequently it is used and to what extent it results in a different outcome from the original complaint decision • A clear policy regarding customer redress, as well as the extent to which redress policies take account of customers affected by the issue giving rise to the complaint but who have not themselves complained • A process to ensure that complaints relating to intermediaries (or, in the case of intermediaries, complaints

2.18. Use of technology	• Where insurers or intermediaries make use of new, relatively untested technologies or non-traditional strategies (relative to norms in the market concerned) to promote, distribute or service their products or services, such practices may introduce new sources of conduct of business risk.
2.19. Quality of IT infrastructure	• The robustness and effectiveness of an insurer or intermediary's IT infrastructure (including related governance and controls) correlates to its ability to meet acceptable conduct of business standards. Infrastructure should be adequate in light of the nature, scale and complexity of the business concerned and its associated conduct of business requirements.
3. Indicators of risks arising from economic and environmental factors	
Indicator	**Potential implications**
3.1. Levels of consumer indebtedness in target market	• An insurer or intermediary operating in a target market where a high proportion of consumers are over-indebted, may give rise to additional risk • Risks of inappropriate policy lapses or surrenders may increase in such markets; trends in this regard may have implications for customers.
3.2. Extent of customer exposure to market performance	• Products where returns are dependent on market performance pose higher risk of benefit expectations not being met than those with guaranteed or non-market related returns. This risk is exacerbated in periods of low or volatile performance of the investment classes concerned • Relevant issues could include: the suitability of such products for relatively vulnerable customers; the quality of disclosures and whether they adequately highlight potential risk; the extent to which ongoing information is provided to manage customer expectations; the fairness and transparency of product and adviser charges, particularly where these are dependent on the nature or performance of underlying investments; customer trends in regard to the proportion of money being placed into higher risk products or investment switching trends.
3.3. Extent of involvement in high risk market wide practices	• Particular market wide product types, business models or other practices may pose high conduct of business risk; insurers or intermediaries that specialise or participate extensively in such practices may need to pay particular attention to appropriate risk mitigation measures.

Annex II

Example from United Kingdom: Payment Protection Insurance

The PPI product

Payment Protection Insurance (PPI) was sold to borrowers alongside credit products. It was meant to help repay some or all of their borrowing if they lost their income for a period (if, for example, they had an accident, became unemployed or sick, or died). The most commonly sold types of PPI were single premium policies on unsecured loans (around 48% of all PPI policies sold), credit card PPI (around 36%), and regular premium policies on loans or mortgages (around 15%). PPI was not a simple product. It had complex pricing (premiums) and benefits, and detailed policy conditions (including eligibility criteria, exclusions from cover and limitations to benefits). Such details meant that PPI was suitable for some consumers but not suitable for all. Firms should therefore have exercised particular care when trying to sell it.

PPI mis-selling and the FSA's actions

For reasons that were eventually set out in detail by the Competition Commission, PPI proved highly profitable to the firms who sold it (particularly in its single premium form). Too many firms too often failed to give a balanced presentation of the product's pros and cons, or to ensure that a policy was suitable for the consumer's needs. As a result, PPI sales grew rapidly through the 1990s, peaking in 2004. Between 1990 and 2010, around 45m policies were sold, worth £44bn in premiums.

Around two thirds of these PPI sales were made before the Financial Services Authority (FSA) – the predecessor to the Financial Conduct Authority (FCA) – took on the regulation of non-life insurance selling (on 14 January 2005). The FSA was aware from the outset of potential issues with PPI, but believed its new regime for non-life insurance sales would address the concerns that had been raised. The FSA assessed firms' compliance with the new requirements in a thematic review of PPI selling practices in 2005. This identified and set out significant shortcomings in many firms.

During 2006-08, the FSA conducted further extensive reviews (including major mystery shopping exercises) across all sectors of the PPI market. The FSA issued three further updates, explaining the continuing, mainly disappointing, findings from its reviews. The FSA also took enforcement action against 28 firms and seven individuals, with each Final Notice detailing the firms' sales failings and imposing fines.

The extensive selling of PPI finally contracted in early 2009, when the FSA secured an agreement from the industry that it would immediately stop selling single premium PPI. This came ahead of the Competition Commission's proposed prohibitions on selling single premium policies and on selling any PPI at the same time as a credit product. More targeted selling of regular premium protection policies has continued since 2009. Such policies can still meet some consumers' genuine credit protection needs.

The FSA's PPI work then focused on ensuring that firms gave fair assessment, and, where appropriate, fair redress, to consumers who complained they had been mis-sold PPI. In August 2010, the FSA introduced additional measures to improve significantly firms' handling of PPI complaints. The banking industry challenged these measures in the High Court, but this was unsuccessful, and from April 2011, the FSA's supervisory work was able to move forward. The FSA began reviewing whether firms had successfully embedded the new measures and were generating fair outcomes for consumers' PPI complaints.

Lessons learned by the FCA

In hindsight, the profits generated for PPI sellers were so large that the FSA's warnings and fines were not enough to change firms' behaviour. The FCA factored this conclusion, and other important lessons from the PPI story, into the design and approach of the new Financial Conduct Authority (launched in April 2013). The FCA has discussed these changes at length in previous publications, but, to summarise, the FCA learned that they needed to:

- conduct more market analysis, so they can reach a better understanding of whether markets are operating well and of how best to resolve any market problems they identify
- seek out the root causes of problems and deal with them at an early stage, because prevention is better than cure
- make more use of our supervisory judgement
- promote competition in the interests of consumers, which will enable them to take a wider range of more effective actions to address complex issues like PPI in future
- look more closely at the risks to consumers from products' features and design, including restricting their availability where this is necessary to protect consumers
- pursue a more intrusive supervisory framework which closely examines the largest firms' business models (to see where they are making profits or seeking growth), culture (to ensure this puts consumers at the heart of the business model), and financial incentives to staff (an important potential driver of mis-selling) and
- engage more directly with consumers and their representatives, so the FCA can understand their concerns, and be more informed about consumers' actual behaviour.