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Conduct risk — Increasing regulatory focus to align product, customer and value

Preparing for the future
Evolving Insurance Risk and Regulation Chapter 2

June 2016

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Conduct risk - Increasing regulatory focus to align product, customer and value

In the period immediately following the financial crisis, regulators across the globe focused on strengthening the resilience of insurers by applying higher solvency standards and enforcing greater oversight from the risk management functions. However, customers still continue to feel a sense of mis-trust in the insurers that they interact with and examples of customer detriment continue to emerge. On top of this, the way that insurers interact with their customers is evolving with an increase in digital interaction. This includes the growth of insurance in new markets leveraging digital solutions to meet the needs of new consumers.

Causes of poor conduct and the regulatory response

The causes of poor conduct are many and are often deeply embedded into an organization's culture and procedures, often driven by information asymmetry in sales and communications, lack of customer understanding and poor product design. The IAIS and other regulatory authorities are taking action in a number of areas.

Now that a range of global solvency and prudential standards have been implemented, regulators are increasingly shifting their focus to address the root causes of poor customer outcomes and focusing on the conduct and consumer protection agenda.

At a global level, of the 26 insurance core principles (ICPs) initially developed by the IAIS, only one (ICP 19) focusses on conduct of business requirements with the remainder focusing on prudential requirements.

However, the IAIS has recently supplemented the ICP by releasing two issues papers in relation to conduct risk, one of which applies to all insurers[1] with the other focusing on conduct risk issues specifically in relation to inclusive insurance[2].

> "We are seeing the IAIS drawing on local expertise and examples of poor conduct from countries such as the UK, Australia and South Africa in a drive to harmonize international standards."

[1] IAIS issues paper on Conduct of Business Risk and its management, November 2015

[2] IAIS issues paper on Conduct of Business Risk in inclusive insurance, August 2015

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What are the main factors causing customer detriment that regulators are seeking to address?

Information asymmetry in sales and communications

Poor product design

Ineffective culture.

Potential sources of conduct risk

The IAIS summarized the following sources of conduct risk:

Inherent factors	aspects such as the intangibility of insurance products and the poor financial literacy of customers including the way that customers behave when selecting financial products
Factors relating to governance and procedures	approaches to conduct across the organization including ownership from the Board; conflicts of interest and incentives; firms approaches to product design and product governance
Economic and environmental factors	technology and wider market practices; and competition from new entrants and disrupters.

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Cause of poor conduct: information asymmetry

Information asymmetry exists in sales of insurance products as the provider of a product often has a detailed and in-depth understanding of a product whilst a consumer is generally less well-informed. Customers generally place a degree of trust and reliance upon the sales person to provide personalized advice based on their best interests and to provide them with adequate and clear disclosure regarding the product or service. This is particularly true of certain channels and products such as the distribution of microinsurance in Africa where reliance is placed on the person providing advice.

Globally, regulators have criticized the sales process and clarity of customer communications, identifying this as a driver of poor customer outcomes which can leave customers with products that do not perform as expected. An interesting trend has emerged whereby market participants in developed economies focus on over-disclosure to ensure customer understanding and participants in emerging economies often provide little documented communication at all. A new risk is also emerging with an increasing focus on financial innovation sometimes creating unexpected and unique customer impacts (for example, the use of social media to promote products).

In the UK, structural reforms in the retirement income market have led to a market shift in the products offered (with an increased demand for draw down products). Firms are faced with the challenge of explaining underlying risk and investment profiles, justifying fee structures and providing the right balance of information to customers to allow them to make a decision without becoming confused.

Future regulatory changes stemming from the Insurance Distribution Directive (see page 5) are likely to increase the focus on product design and ongoing governance. This is further evidence of a global trend whereby regulators are seeking to more clearly define the roles of product providers and product manufacturers.

Cause of poor conduct: weaknesses in product design and product governance

One of the key developments emerging from the financial crisis was a broad review by many regulatory authorities of their regulatory structures and regulatory toolkits and the specific actions that supervisors could take with firms such as information gathering, investigations and enforcement. As product design and governance have been identified as key weaknesses of firms in multiple jurisdictions, some countries have provided their conduct supervisors with additional powers to make interventions and even ban particular products.

Firms themselves will only truly embed conduct risk management into their business by looking beyond the potential regulatory enhancements. Good conduct is

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Local development

The Insurance Distribution Directive: Development in the EU

The Insurance Distribution Directive (IDD) has been developed to replace the Insurance Mediation Directive to provide a level playing field for intermediaries irrespective of whether they are an insurer. The directive will apply to all insurance intermediaries that sell directly to consumers including price comparison sites. These reforms aim to address some of the conduct risks that arise as a result of the traditional manufacturer/provider model and ensure that both parties have a clear role in product design and governance. Key aspects of the IDD include:

- **Registration** – firms will need to register with their competent authority in their home country and also notify them of any other jurisdictions where they intend to deliver services. EIOPA will maintain an electronic list of jurisdictions in which firms intend to operate in.
- **Professional development and training** – professionals must complete a minimum of 15 hours per year. A proportionality principle will apply based on the nature of the products, type of distributor and the individual's role.
- **Conflicts and disclosure** – firms will be required to show the relationship between the insurer and intermediary and the type of remuneration in place. Actual levels of remuneration and commission will not need to be disclosed. Fees will need to be disclosed if these are paid directly by the customer.
- **Product governance** – to ensure products meet needs of target market, insurers and intermediaries who manufacture insurance products should maintain, operate and review a process for the approval for each insurance product. This will also include an ongoing requirement to reasonably assess that products are reaching their target market.
- **Advice** – firms will be required to provide a personal recommendation setting explaining why the product meets the customer's needs.

The European legislation is due to be transposed into local legislation in 2018. As the directive is 'minimum harmonisation', countries will be permitted to apply stricter standards if they consider that they are required to enhance overall consumer protection.

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not simply about ensuring customer satisfaction but delivering a good outcome for the customer. This goes beyond processes and procedures – good conduct should deliver value for both the customer and the shareholder, with a balance of customer outcome and profitability for the firm. For example, by considering the specific conduct risks that could potentially arise from a particular product penetration strategy, Boards can make a better decision around whether to launch the product, ensure that sufficient transparency around the risks and exclusions are provided to policyholders and reduce the risk of any future, potentially costly, remediation action required by regulators concerned that the product has been mis-sold.

In some markets, product and channel innovation lead to new conduct challenges. In emerging economies these can exist where channel innovation has emerged as a primary mechanism to bring insurance to new consumers with developments such as microinsurance and robo-advice. Regulators will need to evolve their approaches to conduct in such areas. We are already seeing examples of such approaches – Tanzania has developed the Micro Insurance Act to govern the distribution of micro policies[3].

Cause of poor conduct: culture

Conduct also requires consideration of the wider culture of the firm. As we describe in our publication, *Financial services cultural assessment and transformation*, firms quite often use the term culture and conduct interchangeably. Culture is often described as, 'the way things are done around here'. It is a complex mix of a broad range of drivers and includes people, performance, individual beliefs and leadership. It is difficult to ensure good conduct where poor culture exists.

Although it is a global challenge, protecting the consumer remains a national issue with very divergent approaches taken between countries. As a result, insurers have approached conduct in different ways - there is no single right answer. Some firms are building an assessment of conduct risk into their risk framework fully and others are identifying conduct as a subset of operational risk. With increasing focus from national supervisors it is clear that doing nothing is no longer an option.

"Firms themselves will only truly embed conduct risk management into their business by looking beyond the potential regulatory enhancements."

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Local development

Microinsurance: Developments in Tanzania

Microinsurance has grown rapidly in emerging markets, mainly in Africa where insurers are using both technology and product innovation to reach customers that were traditionally uninsured. Microinsurers have a number of distinct conduct challenges to address which arise in this unique business model. Examples of some of the unique conduct risks include:

- opportunity for fraud/abuse of verifications provided by smartphone
- limited information disclosure at point of sale leading to potential for lack of customer understanding
- potential for mis-selling with sales utilizing empathy and relationships often requiring multiple conversations before customers purchase a product.

In Tanzania[3], primary legislation has been developed to reduce the likelihood that the issues mentioned above would arise. The legislation sets out a framework for microinsurance legislation including:

- the registration of microinsurance agents
- requirements for microinsurance policies and products
- training requirements and commission arrangements; and
- requirements for complaints handling.

[3] Insurance Act, Microinsurance regulations 2013, Tanzania IAIS issues paper on Conduct of Business Risk in inclusive insurance, August 2015

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Local development

Retirement: Developments in the U.S.

In the context of consumer protection, retirement security in the United States and the role of life insurers as an important provider of guaranteed retirement income, primarily through annuity products has received significant attention. The U.S. Department of Labor (DOL) has released a proposed rule to expand the types of retirement investment advice covered by the fiduciary protections of the Employee Retirement Income Security Act of 1974 (ERISA).   The final rule revises access to, and use of, products designed to provide a lifetime stream of income during retirement.

The DOL aims to create enforceable standards requiring advisers to act in the best interest of their customers. It redefines a "fiduciary" to include persons that receive compensation for giving retirement investment advice to a plan or its participants or beneficiaries, and affects advisors that:

- extend investment advice as a single recommendation rather than on a regular basis
- recommend taking a distribution as to the investment of securities or other property to be rolled over or distributed from a (401K) plan or an IRA
- sell variable annuities to IRA's, and requires them to adhere to a Best Interest Contract Exemption (BICE).

Issues raised by the insurance industry

The insurance industry remains concerned with several issues, including the impact of exemption revisions to:

1. record keeping and disclosure reporting costs
2. proprietary product sales
3. reasonable compensation
4. investment education
5. variable annuity sales
6. fixed-index annuity sales
7. definition of commissions and commission structure.

Issues concerning broker-dealers and advisers

Many financial services firms anticipate the rules will significantly impact existing IT, compliance, and operations functions resulting from:

1. fragmented system and account architecture
2. increased compliance costs and responsibilities for agency transactions
3. disclosure requirements
4. retooling certain customer service and marketing models
5. changes to compensation structures
6. compliance window.

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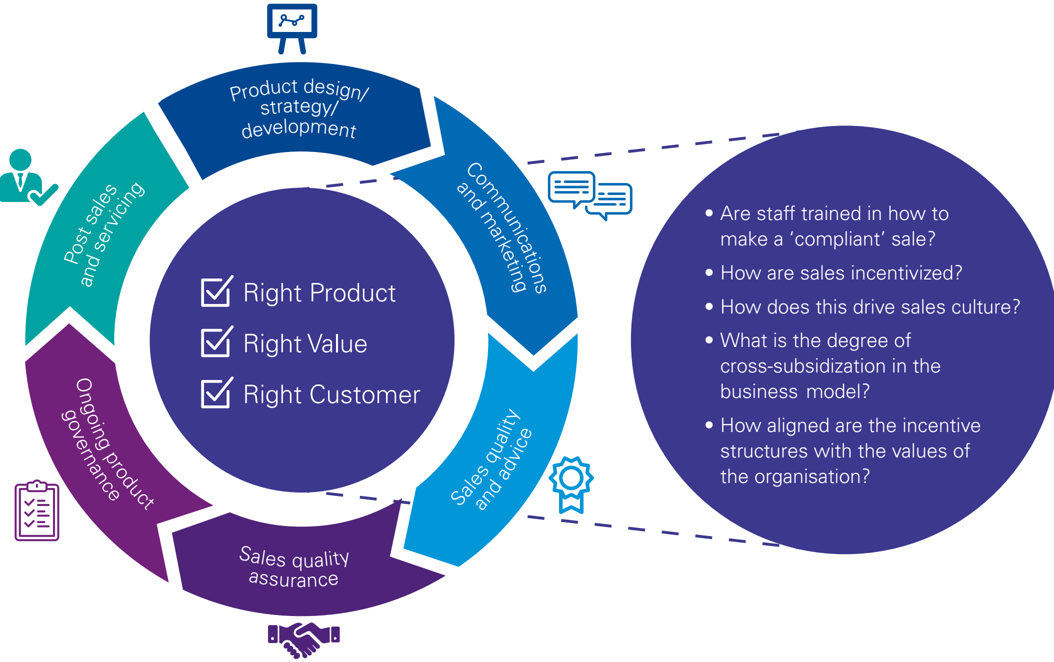
Beyond regulation: developing an approach that goes beyond regulatory requirements

Conduct risk is driven by multiple factors in a firm's business model. Firms must address each of the drivers of poor conduct (shown in Figure 1) when developing and embedding their conduct risk framework.

Figure 1: Drivers of conduct risk



Source: KPMG International 2016

Product design/strategy/development

What are the drivers of organization/business unit level strategy?

How are revenue goals balanced with the long-term sustainability of the business model and customer needs?

What are the values of the organization and how are they driven through policies and processes to create positive customer-centric culture?

Does product design focus on delivering to customer needs?

Communications and marketing

What processes are in place to ensure that customer communications are clear and fair and do not mislead customers? Are they effective?

Does the firm's brand and values drive honest and open communication with customers?

Sales quality and advice

Are staff trained in how to make a 'compliant' sale?

How are sales incentivized? How does this drive sales culture?

What is the degree of cross-subsidization in the business model?

How aligned are the incentive structures with the values of the organization?

Are there clear controls in place that ensure consistently good customer outcomes?

Sales quality assurance

What processes are in place to provide assurance over the quality of sales and customer outcomes?

How effective are they? Do they measure conduct risk?

Are first line supervision arrangements appropriate and effective?

Ongoing product governance

How are emerging and crystallized risks measured, monitored and identified?

How are customer risks in the product design or sales process mitigated?

What are the drivers for product enhancements?

Post sales and servicing

How are good customer outcomes ensured post sale?

Are customer needs and expectations central to policies and processes regarding arrears management, claims and servicing?

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Key considerations for building a conduct risk framework

Environmental context	Underlying external environment that affects the strategy including regulatory influences and competition.
Design of strategy	How customer needs and commercial targets influence strategy development and product development.
Execution of strategy	Appropriateness of policy, processes and controls to deliver and support the strategy.
Market positioning	Approach to pricing and promotion of the strategy or product.
Infrastructure to support execution	Resources and systems to support the strategy.
Risk culture	Establishing the right attitudes and norms of behavior in decision making.

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Local development

Add-on insurance: Developments in the UK

The use of add-on premium options at expensive premium rates to existing insurance coverage has come under increasing focus by both UK regulators and the Australia Securities and Investments Commission (ASIC) in their review of home insurance. The UK Financial Conduct Authority (FCA) has levied heavy fines on some insurers for inappropriate use of such practices.

The FCA undertook a review which concluded that selling products as an add-on has an adverse impact on customer decision making. The FCA was concerned about abuses of the innate sales bias, as the provider can utilize their point-of-sale advantage, including choice and competition.

The review focused on five products: guaranteed asset protection (GAP) insurance, home emergency insurance, travel insurance, gadget insurance and personal accident insurance. It concluded that customers often receive poor value for money.

To address these issues, the FCA has proposed a four-pronged approach that includes:

- Imposing a deferred opt-in period in GAP sales and requiring insurers to provide additional information to aid comparison and shopping around.
- Introducing an opt-out sales ban.
- Requiring insurers to improve the information provided to customers in relation to general insurance add-ons.
- Undertaking a pilot to consider whether to introduce a formal measure for value for money in general insurance add–on products. This would be based on factors such as claims ratios, frequencies, acceptance rates and average claims payouts. In future, this could include a requirement to report such factors to the regulator.

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Helping make the best insurers better

Are you confident your business is ready for a rapidly changing world?

As risks evolve and regulatory requirements shift, KPMG firms help insurance organizations stay on top of their regulatory obligations and evolving compliance requirements. These teams help insurers improve their governance and oversight and build sustainable risk target operating models to support business certainty, flexibility and growth.

Insurance clients frequently call upon KPMG firms to help with:

- The development of a wide-ranging vision and approach to governance, risk and compliance.
- Providing assistance in developing and maintaining a conduct risk framework assessment to deliver good customer outcomes.
- Solvency II assurance, building and validating capital models, reporting guidance, systems transformation and program assurance.
- Designing 'Own Risk and Solvency Assessment' processes, including ORSA gap analysis, planning, training and application.
- Assurance on the adequacy of reserves and pricing for property and casualty business.
- Climate change and sustainability issues fueled by stakeholder demands, emerging environmental risks and a desire by insurers to fulfill their broader social purpose.
- Cost and capital optimization strategies to improve gross margins, and better align cash, cost and working capital to business and operational goals.
- Simplifying and maximizing the benefits of enterprise risk management (ERM) systems by improving risk processes, systems, reporting, governance and the risk target operating model.
- Assessing and mitigating key vulnerabilities from fraud and misconduct to cyber crime, through forensic discovery services.
- Conducting cyber maturity assessments, security architecture development, application security assurance, identity and access management and security testing.
- Assisting clients to respond to and manage the consequences of the tax rules.

The Insurance Risk and Regulatory Centres of Excellence support insurers who face complex regulatory changes globally or in individual jurisdictions. Our member firms' top regulatory experts provide practical insights into the implications of regulatory issues helping insurers identify risks, understand new compliance requirements, and plan necessary changes and support implementation ahead of time.

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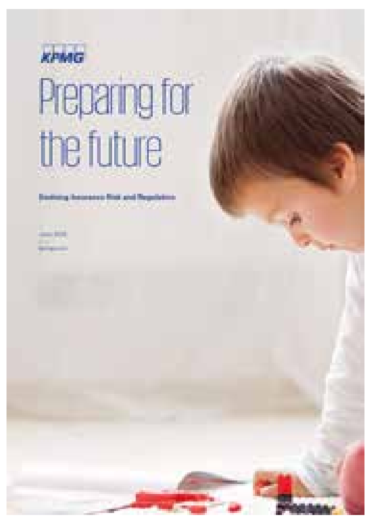

Evolving Insurance Risk and Regulation is an annual report published by KPMG International covering the key regulatory topics facing the Insurance industry. This report is in its sixth year of publication, and this year, it is evolving with what we see happening in the market, notably, adding "risk" to the title. Another change to this year's report is that it will be published as a series of chapters with the first chapter launching alongside the IAIS event in June, and concluding with our first ever Risk and Regulatory benchmark survey to correspond with the IAIS meeting in Paraguay in November.

This is the second chapter in the series. The first chapter, "International developments dominate regulatory change," covered the major regulatory themes happening globally, based discussion with our member firms' clients, our professionals' assessment of key regulatory developments and through our links with policy bodies in each region. The third chapter will look at the regional regulatory developments happening around the globe on a country-by-country basis. Additional chapters and analyses will be published monthly with the final installment of the results of our benchmark survey that will be presented in Paraguay.

Visit www.kpmg.com/regulatorychallenges for more information, or reach out to fsregulation@kpmg.co.uk.

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