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Background in numbers: Why conduct and culture matter

2,800<sub>3</sub>

£452 million<sub>1</sub>

£14 billion<sub>2</sub>

76,000<sub>1</sub>

£104 million<sub>2</sub>

Sources:  
1. FCA Business Plan 2014/2015  
2. [www.fca.org.uk](http://www.fca.org.uk)  
3. FCA Business Plan 2013/2014

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## The Eye of Wheatley?



A screenshot from the video game Portal 2. The image shows the 'Eye of Wheatley', a large, fiery, eye-like structure with a face, set against a dark, industrial background. The eye is composed of a bright orange and yellow flame-like core with a black pupil and a small, smiling mouth. It is flanked by two tall, thin, metallic pillars that form a V-shape. The background is a dark, cavernous space with a bright light source on the right, creating a silhouette effect on the surrounding structures.

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Agenda

1

Supervisory framework

2

Conduct risk management

3

Deep dive on product governance

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Conduct risk – FCA  
Approach

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Happy first birthday – Not resting on our laurels!




*"There are still many challenges ahead. The global financial crisis may be receding but industry-wide culture change does not happen overnight.*

*If the first year has seen the concept of good conduct go to the top of the agenda in boardrooms across the City, in our second year we must push for this culture change to feed through from trading floors to high street bank branches."*

Martin Wheatley, FCA Business Plan 2014

*"We hope by highlighting these ... seven areas of focus, to increase the likelihood that firms will be able to avoid them or to minimise their impact and the detriment they cause."*

John Griffith Jones, Chairman FCA, RCRO 2014



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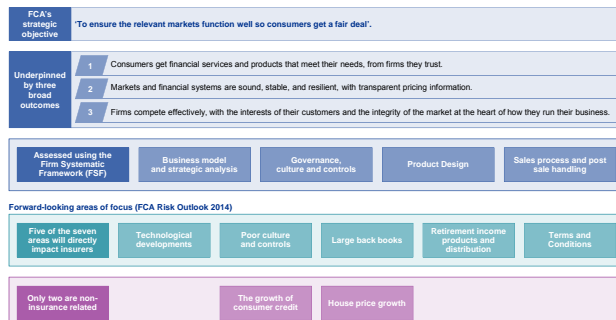
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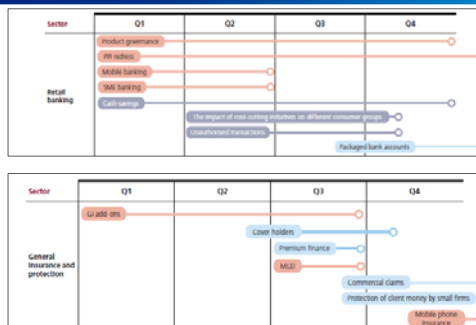
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## FCA agenda for insurers



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## Current and planned thematic work and market studies in insurance 2014



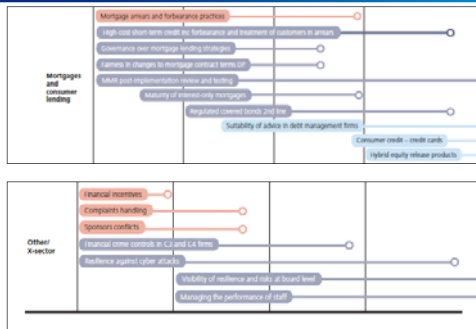
Source: FCA Business Plan 2014/2015

## Current and planned thematic work and market studies in insurance 2014 (II)



**Source: FCA Business Plan 2014/2015**

## Current and planned thematic work and market studies in insurance 2014 (III)



Source: FCA Business Plan 2014/2015

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## Conduct risk management

What is conduct risk?  
Defining conduct risk

Below are some market interpretations/definitions of conduct risk:

*"Conduct Risk is defined as the risk of regulatory censure and/or a reduction in earnings/value, through financial or reputational loss, from inappropriate or poor customer treatment."*

Firm A: Large Retail Bank

*"The risk of creating detriment to a client, counterparty, the Group or market arising from inappropriate conduct of business."*

Firm B: European Capital Markets

*"The risk that we treat our customers unfairly and deliver inappropriate customer outcomes."*

Firm C: General Insurer

*"Conduct Risk is the risk that detriment is caused to our customers, clients, counterparties or the Bank and its employees because of inappropriate judgement in the execution of our business activities."*

Firm D: Large Retail Bank

*"The risk that the conduct of the Group and its staff towards our customers or within the markets in which we operate might lead to damage arising from breaches of regulatory rules or law, or of our customers' or regulators' expectations of us."*

Firm E: Large Retail Bank

Firms have the opportunity to define Conduct Risk in a way which is relevant and appropriate to their business

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Conduct risk quantification

From a fundamental perspective putting a value on Conduct Risk should be straightforward considering the drivers of risk to a life insurance company and its customers:

Product design risk

Should be set very low

Product design risks

- Intrinsically complex.
- Target market difficult to identify with precision.
- Potential misalignment with regulatory standards or expectations.
- Represents poor value for money for customers.
- Product profitability.

Execution risk

Should be set low

Execution risk

- Poor staff understanding and/or weak T&C.
- Process deficiencies or manual workarounds.
- Suitability of advice not demonstrable.
- Adverse impact of sales targets and reward and incentive.
- Control weakness/failure.
- Sales volume volatility.

Environment risk

Low probability, high impact

Environment risk

- Product performance.
- Macroeconomic factors.
- Regulatory intervention and focus (at product/industry level).
- Media or consumer group focus.
- Emerging themes from Conduct Risk Outlook.

Cost

Reputation, Customer Confidence, Market Share, Financial Penalty, Back Book Review, Remediation, More Intrusive Regulation

Investment in conduct risk mitigation

versus

the cost of repeated public and regulatory scrutiny

Conduct Risk: the risk of (mis)selling a product to a customer that the product was not originally designed for

$$P_{CR} = 1 - ((1 - P_{CD}) \times (1 - P_{PR}) \times (1 - P_{ER}))$$

Where  $P_{CD}$  = Probability of Conduct Risk Event

$P_{PR}$  = Probability of Product Range Risk

$P_{ER}$  = Probability of Execution Risk

Consider the difference in approach today between Standard Life's Financial or Insurance Risk departments and its Conduct Risk teams...in terms of budget, systematisation, alignment of key stakeholders, influence, degree of proactivity, integration of technology etc.

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Conduct risk –  
Product governance

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Existing product governance structures need to be re-evaluated

More than 1 out of every 4 of the respondents to the KPMG Technical Practices Survey could not say that they considered their companies' Product Governance processes to be robust enough to satisfy the Conduct Risk requirements under the FCA.

YES

NO

NOT CONSIDERED

71%

6%

23%

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Good product governance is a competitive advantage, the alternative less positive

Failure to apply appropriate product governance could result in fines/censure from the FCA:

FCA fines Swinton Group Limited £7.38 million for mis-selling monthly add-on insurance policies

"Swinton failed its customers. When selling monthly add-on policies, Swinton did not place the consumer at the heart of its business. Instead it prioritised profit." – Tracey McDermott

FCA website, July 2013

FCA fines Lloyds Banking Group firms a total of £28,038,800 for serious sales incentive failings

"Customers have a right to expect better from our leading financial institutions and we expect firms to put customers first – but firms will never be able to do this if they incentivise their staff to do the opposite." – Tracey McDermott

FCA website, December 2013

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Example terms found in policy documents

Below are some examples of actual terms and conditions that either result in the products not performing as expected, or make it difficult for the consumer to understand how the product will perform:

"...where ongoing treatment was required indefinitely we would look to withdraw cover back under the care of the NHS if available as the XYZ policy does not cover long term monitoring or preventative treatment."

Cancer benefit, Private healthcare provider

"...claims that are incurred as a result of flying are excluded..."

Critical illness benefit, Multi-line insurer

"If you are not in gainful employment or gainful self employment you will be considered to be incapacitated if you are unable to undertake at least three of the tasks from the activities listed: Bending, Communicating, Reading, Walking, Fine motor control"

Income continuation insurance, Multi-line insurer

"We cover children from the age of 30 days... we exclude any condition that was present at birth"

Child critical illness benefit, Multi-line insurer

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Elements of good product governance

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graph TD; Governance((governance)); Culture[Culture & responsibilities]; Policies[Policies, processes and incentives]; Research[Research and stress testing]; Value[Value for money]; Mgmt[Management information]; Culture --> Policies; Policies --> Research; Research --> Value; Value --> Mgmt; Mgmt --> Culture
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Elements of good product governance  
Customer experience at claim stage



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Value for money

**The FCA has been vocal about the importance of value for money.**

- “It is necessary for the regulator to make judgements on the value for money of products, and to possess the powers to take action.”
- “The FCA will go further than the FSA in challenging providers on the value for money of their products.”
- “Both investors and advisers can compare the costs of investing through different platforms and make an informed decision on whether using a platform represents good value for money.”
- “The FCA is considering exercising its powers to take action where costs or charges are excessive.”

**How are you going to assess:**

- Value for money?
- New Products?
- Back-book?

The price of a product is derived based on a number of factors. These factors should be balanced to achieve value for money.

Value for money cannot be based solely on an objective assessment of cost and benefit. Some elements of value are not financial.

Peace of mind	Brand value	Customer satisfaction
Simplicity of product	Perceived service	Feature optionality

Value for money will depend on the context of the customer and their ability to understand the product features and risks.

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Over to you

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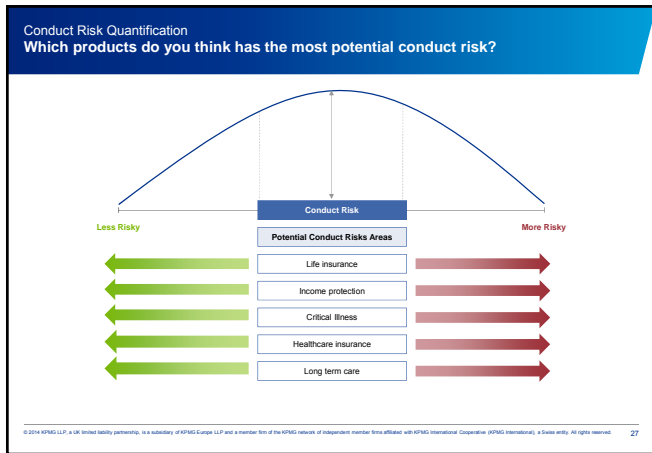
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