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Striking the right balance
A proportionate approach to conduct risk in wholesale insurance markets

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Whether you are a marine broker, terrorism underwriter, or property Managing General Agent (MGA); the Financial Conduct Authority (FCA) now requires conduct risk (the risk of unfair consumer outcomes) to be identified and mitigated in wholesale insurance markets.

This is a huge step change for firms, especially for brokers and underwriters operating in the Lloyd's and London market (plus other insurance companies with commercial lines business). With limited conduct focus until now, many firms have business areas that have never assessed conduct risk and there is little precedent or guidance on how to appropriately mitigate the risk.

There is a real danger that firms address conduct risk disproportionately or without mitigating the actual risks. It is essential to get the balance right: there are undesirable outcomes for both firms and consumers if mitigating actions go too far, or not far enough.

Finding a risk-based and proportionate solution that works for the Lloyd's and London market is therefore critical to the market's continued success. However, without any prescriptive regulatory rules or guidance, the many 'grey areas' of conduct risk that need to be addressed present a barrier for firms when tackling the overall conduct risk agenda.

In this paper we explore these challenging 'grey areas' and offer an approach that firms in the wholesale insurance market can use to identify and mitigate conduct risk.

Key points

- By tackling conduct risk issues without an appropriate methodology, there is a danger that brokers and underwriters address conduct risk disproportionately or without mitigating the actual risks.
- Firms need to break-down, analyse and prioritise complex business models to focus on where there is exposure to conduct risk in a structured, risk-based and proportionate way.
- Firms should re-focus existing processes and controls to address the identified conduct risk, before complementing these with additional proportionate steps where necessary.
- Firms that succeed in their conduct risk approach can expect:
  – operational efficiencies
  – improved strategic decision-making
  – a new perspective for boards and committees
  – a forward looking view of conduct risk.

The expansion of conduct risk into wholesale insurance markets

Conduct risk was traditionally seen as only a concern for retailers of personal lines. It was typically these firms making the front-page news and receiving multimillion pound regulatory fines for failing to address conduct risk.

However, the FCA has dramatically widened the scope of conduct risk to cover:

- all firms in the supply chain, including firms operating in wholesale markets

"We will take a more assertive and interventionist approach to risks caused by wholesale activities and, if necessary, will act to protect a wider range of client relationships than at present."

FCA – Journey to the FCA, 2012

- all consumers of general insurance, from personal lines to commercial lines – including large risks and reinsurance

"Our responsibilities extend to all consumers, whatever their age or financial circumstances and whether an individual, small company or a major participant in the wholesale markets."

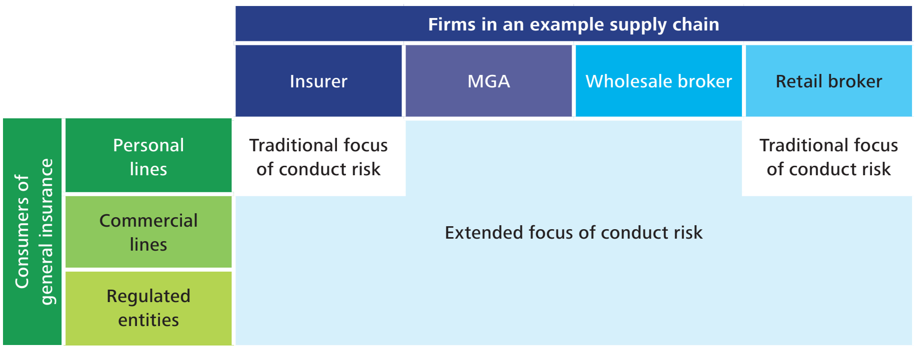
FCA – Approach to Advancing Objectives, 2013

This scope change has brought new firms, regulated activities, lines of business and products into the focus of conduct risk. This has wide-ranging consequences as firms must demonstrate that consumers are central to their business model, product lifecycle and culture. It therefore impacts from how firms make strategic decisions to how people are incentivised, and everything in between.

"We will take action, including enforcement action, where we consider that part of a firm's business model or culture – such as its product selection, training and recruitment, or remuneration practices – are likely to harm consumers."

FCA – Approach to Advancing Objectives, 2013

Figure 1. Extended focus of conduct risk



Source: Deloitte Analytics

The matrix of firms and consumers in figure 1 shows that insurers and retail brokers operating in personal lines fell into the traditional focus of conduct risk. Other firms in the supply chain, firms operating in the commercial lines market, and how firms interacted with each other, historically fell outside the scope of conduct risk, but are now also explicitly within focus.

Key conduct risk challenges

Challenges are inevitable given the complexity and diversity of wholesale insurance markets. Below, we examine a number of key risks, challenges and 'grey areas' that wholesale insurance firms must overcome when addressing conduct risk. While this is not an exhaustive list, we have highlighted those areas where we believe the need for consideration is most significant.

CONSUMER SOPHISTICATION

Now that all consumers of insurance (from individuals, to corporates, to regulated entities) are viewed by the FCA through a conduct lens, how should firms assess conduct risk posed by different consumers?

It is generally assumed that the greater the financial understanding of the consumer – for example, a large corporate compared to an individual – the less likely there will be an unfair outcome and the lower the conduct risk.

The traditional segregation of consumers into personal lines and commercial lines is too simplistic to enable a proper assessment of the financial understanding of the consumer and how this heightens or mitigates conduct risk.

For example, what if the purchaser of insurance for a large corporate is an individual in the HR department, with little knowledge of the product being purchased? Or is a medium-sized corporate but a first-time customer or purchaser of the product? These consumers may not actually be sophisticated buyers regardless of the size of corporation.

WHO IS YOUR CUSTOMER?

Who should different firms in the supply chain consider as their customers and what does this mean for conduct risk?

We see many firms simply considering the next party in the supply chain as their customer. For example, wholesale brokers considering their customers to be retail brokers.

It is unequivocal that all firms should look down the supply chain to identify and mitigate conduct risk in relation to the end-insured.

CAN YOU PLACE RELIANCE ON OTHER PARTIES?

As firms across the market address conduct risk, it is possible that every firm in a supply chain undertakes similar mitigating steps, causing duplication, inefficiency and unnecessary cost. This has happened with other regulatory requirements when expectations evolve. Can this be prevented by placing reliance on other firms?

There are many situations where firms may want to place reliance on other parties in the supply chain or on firms with whom they have outsourcing arrangements. For example, a large marine risk placed in the subscription market – the six following underwriters place reliance on the lead underwriter to set the terms of the contract and handle any claims.

Can these followers rely on the lead in the same way to appropriately address conduct risk? How should alternative sources of insurance capacity (for example, side-cars) get comfortable with the conduct risk profile they are absorbing on an open market basis? And can other parties in the supply chain rely on each other? For example, can an insurer or wholesale broker rely on the retail broker who has the main customer relationship?

Following underwriters have exposure to conduct risk but they can place reliance on the lead underwriter's conduct risk mitigating actions to increase efficiency. However, this should not be 'blind reliance' – it requires firms to gain assurance over any reliance placed.

The same goes for any type of outsourced activity (including all types of delegated authority, from Coverholders to Third Party Administrators) and parties in the supply chain relying on each other.

GEOGRAPHIC LOCATIONS

Wholesale insurance is a global business. So what are the conduct risks for a UK regulated entity when the end-insured and/or other parties in the supply chain are domiciled outside the UK? For example, an Indian consumer has an Indian broker who instructs a UK broker to place the risk at Lloyd's.

There has been recent debate in the Lloyd's and London market over the extent of conduct risk responsibility in relation to non-UK domiciled consumers.

We believe that UK regulated firms have a responsibility to identify and address conduct risk in relation to the end-insured, no matter where they are based in the world. This may include mitigating the conduct risk from any information asymmetries with the Indian broker, for example, if the Indian broker has insufficient information on the product to properly represent the end-insured.

While information can be harder to gather, a regulated activity is taking place in the UK and it could be indicative of poor culture within an organisation and damaging to market integrity if decisions are made that produce poor outcomes for consumers based outside the UK.

WHAT IS A 'PRODUCT'? AND WHEN IS IT 'NEW'?

Different insurance products present different conduct risks. However, to assess these risks, each firm will have to find a suitable definition for a 'product' and 'new product' that works for them.

These definitions are likely to vary by firm. The challenge in defining a 'product' comes from the many types of business where each risk is a bespoke product. While it is relatively straightforward where the product is broadly homogeneous, the conduct risk from bespoke products may need to be assessed at a line of business level, although there is often more homogeneity across bespoke products than first appears.

An inappropriate definition of 'product' results in assessing conduct risk at a level that is either too time and resource consuming, or doesn't consider the risks in appropriate detail.

With corporate consumers increasingly de-risking their business through the purchase of insurance, new insurance products will be designed to suit new risks they face.

A challenge comes from ensuring that risks posed by these new and amended products are addressed. Products with little or no history (for example, historic claims data) can present a higher risk of unfair consumer outcomes; and similarly, there is conduct risk when hiring a new team of underwriters or brokers to diversify into new areas that the firm is inexperienced in.

While there has been debate in the market about whether it is the broker or underwriter that has responsibility for product design; in reality, products are frequently designed by both parties working together. This challenge must therefore be addressed by both brokers and underwriters.

CONFLICTS OF INTEREST

Conflicts of Interest (COI) is a key area of focus for the FCA. Firms need to consider the conduct risk presented by different types of COI and how these relate to different areas of their business, but what types of COI should be identified and how should firms mitigate the associated conduct risk?

COIs are the subject of a FCA thematic review that started in 2013 and we have seen standards of identifying and mitigating COIs rise across the market.

It is challenging for firms to keep up with the FCA's evolving expectations around COI. In particular, the type and volume of COIs to identify and how these should be mitigated.

For example, if a broker is choosing which market to place a consumer's risk, it is advisable that the broker is unaware of the multimillion pound consulting contract, or sizeable volume commission, his or her firm has with an individual insurer. And on this point, how responsible is the insurer for this COI?

If the broker has the option of placing this risk with a Group-owned MGA, then what steps should the broker take to demonstrate this is in the consumer's best interest? If this risk is placed with a market that pays profit commission (PC) and has delegated claims authority to the broker, the claim handler should be unaware of the PC and not influenced to unfairly decline the claim.

While incentivising brokers and underwriters is central to driving long-term commercial success; incentive structures, such as pure volume-based financial incentives, can also drive undesirable behaviours that conflict with the consumer's interests.

CLAIMS AND COMPLAINT HANDLING

Do firms understand their conduct risk profile in relation to claims and complaint handling?

Claims and complaints are also thematic review areas for the FCA and while personal lines claims have been the main focus in 2013, it is likely that the FCA will turn its attention to commercial claims.

With the FCA's 'follow the money' approach, claims ratios are an important conduct risk factor to consider. Profitable business does not automatically mean unfair consumer outcomes. However, firms should make sure that profits are due to good underwriting or broking, and not because the product has onerous limitations that the consumer is unaware of or offers little value for money.

CHALLENGES FOR REINSURANCE

The consideration of conduct risk in reinsurance is in its infancy. So what are the conduct risk exposures for reinsurance?

If a reinsurer reinsures an insurer's motor book, the insurer is able to underwrite more business. If the insurer's book contains products that cause consumer detriment, the reinsurer could arguably be said to have facilitated this outcome.

So while reinsurance brings a degree of conduct risk, it is proportionately lower risk given the sophistication of the reinsurance-buyer and relative remoteness from the underlying end-insureds.

The conduct risk with Treaty reinsurance is more of a challenge to address than Facultative contracts. For example, a South American risk placed into London through Facultative reinsurance has a similar conduct risk profile as placing the insurance element. However, if a Treaty book is populated with comparable products or with products designed using similar approaches, a conduct risk assessment starts to look less impractical.

Barriers to getting started

It is a challenge for firms in wholesale insurance markets to know where to start when it comes to conduct risk.

Experience. Many such firms have business areas that have never carried out an assessment of conduct risk and each area may have different conduct risk exposures. Even where firms have areas of retail personal lines business and are therefore familiar with the concept of conduct risk, Lloyd's and London market businesses are different beasts. In the absence of a risk-based and structured approach, addressing conduct risk can become haphazard, time-consuming, costly and ineffective.

Regulatory guidance and precedent. There are no prescriptive regulatory rules or guidance and firms are currently tackling individual conduct risk topics, rather than the overall picture. There is also little precedent on what mitigating processes and controls are proportionate. Disproportionate steps to mitigate conduct risk that aren't targeted at the risks or practical for the Lloyd's and London market can stifle competitiveness.

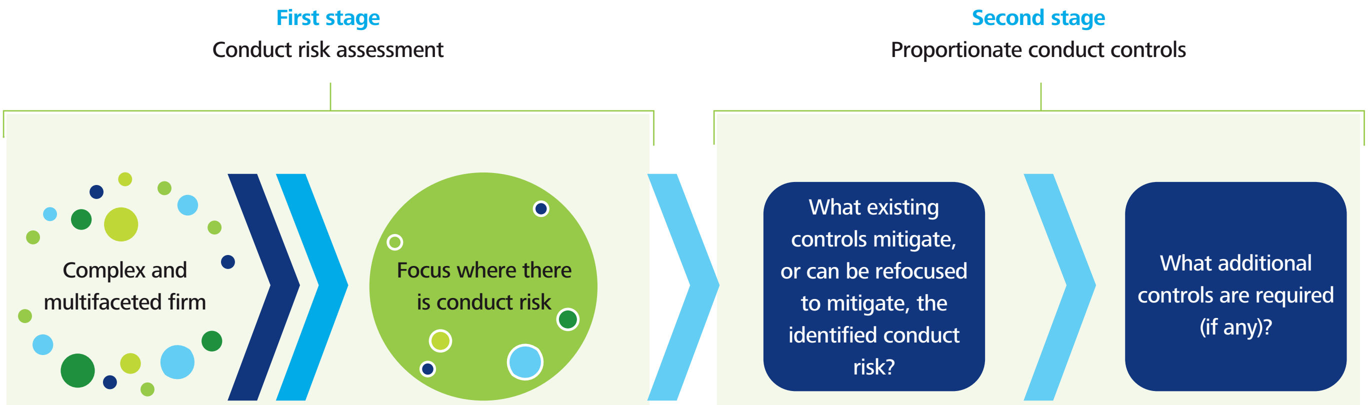
Supply chain co-operation. Firms do not consistently work together to address conduct risk along the supply chain. Firms often lack visibility of the entire supply chain with information shared by parties focused on allowing the risk to be underwritten – not specifically to mitigate conduct risk. While it is understandable that firms want to protect commercially-sensitive information; inadequate communication of information can prevent firms from obtaining the knowledge required to appropriately address conduct risk.

Competition for resource. Firms are identifying knowledge gaps as they look to address conduct risk and as a result are seeking to recruit quality conduct risk resource into key control functions – including compliance, risk and internal audit. However, conduct risk professionals who can apply this knowledge to the complexities of the Lloyd's and London market come at a premium.

A risk-based, proportionate and practical solution

Through collaborative input from key Lloyd's and London market stakeholders, we have developed an approach for firms in wholesale insurance markets to address conduct risk.

Figure 2. The two stages in taking a risk-based, proportionate and practical approach



The first stage is a conduct risk assessment that enables firms to break down, analyse and prioritise complex and multifaceted business models to provide clarity on where there are conduct risks. This provides a clear structure and transparently demonstrates why low-risk business areas need less focus. This is the foundation of a risk-based and proportionate approach.

For example, this conduct risk assessment should enable firms to understand their end-insured profile, so that the sophistication of their consumers can be categorised. It should also identify different incentive structures across the business and how they heighten or mitigate conduct risk. At one end of the spectrum, there may be staff incentivised on purely volume-based financial targets; as opposed to a 'balanced scorecard' of performance objectives that encourages staff to meet quality and regulatory targets, as well as financial ones.

The second stage enables firms to take focused steps to address the identified conduct risk based on the role they play in the supply chain. For example, an insurer could design the product or provide capacity for a product designed by another insurer or broker. This role-based perspective allows these focused steps to be tailored to the actual risk the firm poses to the consumer.

For example, where a firm moves into cyber insurance for the first time or designs a new product, there should be appropriate input, challenge and approval by key stakeholders and governance structures. Where conflicts of interest in specific broking business areas arise from a sizeable consulting contract or volume commission with an insurer; ethical walls can assist in preventing this conflict from materialising and broking file reviews can provide assurance.

To make this second stage work, it is important to make the most of existing processes and controls. We frequently see firms with existing processes and controls that mitigate conduct risk – from Management Information provided to the Board and Committees, to broking or underwriting file reviews. However, these existing mitigating actions are typically focused on commercial outcomes, labelled differently or inconsistently applied across the business. The efficient embedding of conduct risk culture starts with refocusing the existing day-to-day business practices, before complementing these with additional proportionate steps where necessary.

Conduct risk driving commercial success

Firms and the FCA have been developing their understanding of what 'good' management of conduct risk looks like and it is clear that 2014 will be an important year for addressing conduct risk in wholesale insurance markets.

We expect the regulatory focus to intensify, and standards and scrutiny to increase. So it is important that the steps firms take have regulatory certainty but also drive commercial success. Examples of how addressing conduct risk can drive commercial success include:

Operational efficiencies from greater understanding of the conduct risk and control environment. This can ensure greater alignment and consistency of internal processes, in addition to more effective allocation of resource and management focus.

Strategic decision-making on the commercial desirability of business can be better informed by understanding the associated regulatory and compliance costs for effective cost/benefit analysis.

A new perspective for Boards and Committees to view their business, such as what the end-insured profile looks like, and where there are niche areas of business that were previously unsighted.

A forward-looking view of the conduct risk posed by different business areas mitigates the risk of unfair consumer outcomes before they materialise. Identifying conduct risk before consumer detriment means that firms avoid undertaking Past Business Reviews to remediate the detriment, with the associated cost of redress and reputational damage.

It is clear that if properly approached, addressing conduct risk can support strategic decision making and drive long-term profitable relationships with consumers and counterparties.

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