



Conduct risk for insurers

Responding to a fundamental shift
in regulatory expectations

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Message from Oliver Wyman

We interviewed twenty two CEOs and senior executives from across the UK insurance industry to understand their views on, and response to, the FCA's Conduct Risk agenda. Participants covered a broad representation of the industry, including life insurers, general insurers, health insurers and composites.

This report presents our findings from the research and outlines the actions we believe insurers need to take in order to respond to the FCA's main areas of concern.

We hope that you find the report useful for understanding the implications for insurers of a more open, transparent and accountable market, and in considering your approach to managing Conduct Risk.



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Message from the CII

There is no doubt that both the Prudential Regulation Authority and the Financial Conduct Authority have put conduct, culture and public interest at the very heart of their approach following their formation back in April 2013.

As the largest professional body in the UK financial services sector, the Chartered Insurance Institute welcomes this focus on improving the culture of the whole financial services sector and we believe that how professionals behave is as important as what they know. We at the CII have actively promoted higher professional standards across our membership and initiatives including the Aldermanbury Declaration and Corporate Chartered Insurers and Brokers are examples of our desire for the insurance sector to attempt to make its own weather rather than rely on meeting a compliance requirement culture.

As a body that champions higher standards we believe it is right for us to offer challenge to our profession and the insurance sector at large on conduct issues particularly on topics where the public and regulator are demanding more.

This report, produced by Oliver Wyman, is designed to help raise the level of debate on the key conduct issues emerging across the insurance sector, and whilst there will be a range of responses to the analysis and recommendations, it does capture the current thinking of leading practitioners on insurance conduct risk. It should also act as a stimulus for future thinking and action across the insurance sectors – as well as supporting the dialogue with our new regulators.

We hope you find this report a good starting point for a debate the profession needs to have within itself, with the regulators and ultimately part of a larger conversation with the wider public. Let us hope it will lead to a better dialogue and ultimately better solutions to meet the public interest.



Dr Sandy Scott
Chief Executive, CII

Executive summary

Martin Wheatley, Chief Executive of the Financial Conduct Authority (FCA), promised at the ABI's 2013 Biennial Conference that the FCA would be: "a very different animal to the Financial Services Authority (FSA)." He set out a positive vision of a successful and competitive market where regulation is not a zero-sum game, and where customers and the best firms can benefit from more competition, better products and better service.

In its first months of existence, the FCA has undoubtedly been active, with market studies and thematic reviews of insurance products and operations. And there is no doubt that there is some anxiety amongst insurers in relation both to the workload caused by these reviews, and also to their potential impact on existing ways of doing business. However, it is also the FCA's intention that thematic reviews do not simply add up to a succession of bad news stories; good practice and improvement should also be recognised and highlighted.

In order to understand the views of the UK insurance industry towards Conduct Risk more clearly, we interviewed 22 CEOs and other senior insurance executives. These interviews proved to be informative, and exhibited a broad range of views. In summary, we found that:

- There is a mismatch of expectations between insurers and the FCA
- There has been an inconsistent response from insurers in both pace and content
- There are four key emerging issues which will be particularly challenging to address.

“*a very different animal to the Financial Services Authority (FSA)*”

Mismatch in expectations

Our interviews revealed that, for some firms at least, a shift to a more transparent and competitive market is regarded as positive. However, in general we found a mismatch in expectations between insurers and the FCA in three key areas:

1. The role of the regulator, and level of regulatory intervention, required to address deficiencies in the market.
2. The practical implications of the new regulatory regime for firms, and the extent of change required to comply.
3. The level of preparedness and progress by insurers in adapting to the new regime.

Emerging issues

As we consider the speed and direction of the journey towards a much more open, transparent and accountable market, we see four emerging trends that may become particularly challenging for insurers:

1. A focus on good customer outcomes, rather than on actions taken by regulated entities to influence those outcomes. Following the rules is not enough.
2. Defining and proving the value for money of products. Both price and value need to stand up to intense public scrutiny.
3. Pressure to ensure greater equality. This would involve managing the trade-off between individual underwriting and pooling of risks to ensure universal access to insurance, and reducing discrimination between groups or types of customers.
4. Setting the boundaries for the use and management of customer data to ensure that technological progress does not outstrip regulators' and customers' appetite for intrusion.

Insurer responses

In order to respond, we think that insurers should carry out the following five steps:

1. Define their conduct risk appetite and obtain senior stakeholder buy-in.
2. Perform a conduct risk diagnostic to identify changes required.
3. Strengthen tools, processes and controls.
4. Realign their business model with good customer outcomes.
5. Reinforce through leadership actions, culture, training and incentives.

1. The conduct era: more than just a risk type

Consumer protection regulation is not new to the financial services industry, and few would argue against some form of regulation being beneficial to both consumers and firms. However, we consider that the conduct risk agenda being pursued by the Financial Conduct Authority (FCA) represents a major change in expectations, and is much more than just a new version of the Treating Customers Fairly (TCF) principles.

Despite significant progress and positive intentions by many firms, a continuation of incidents related to conduct risk point towards deficiencies in the way the financial services market operates and in the way some firms manage their products and customer relationships. These include:

- Target customer markets and product value propositions can be poorly defined, preventing firms from monitoring good customer outcomes effectively.
- The suitability of individual customers does not always receive sufficient attention, as processes to match products and clients may lack rigour and are insufficiently supported by evidence.
- Product complexity and bundling remain common, making it harder for customers to make decisions in their own best interests without detailed, structured advice.
- Tools and infrastructure are underdeveloped. With conduct risk regulation moving the industry even further away from a simple caveat emptor regime, evidence of due process which succeeds in delivering good customer outcomes is paramount.
- Employee incentives are not always aligned with providing appropriate customer solutions.

Given multi-billion pound taxpayer bailouts and significant political pressure, these deficiencies are no longer being tolerated. Regulators in key markets such as the US (Consumer Financial Protection Bureau (CFPB)) and the UK (FCA) are concentrating their conduct oversight in dedicated teams or separate agencies, while enacting sweeping regulation that covers both a broad array of conduct-related issues and a new model for supervision.

In the UK, the FCA is heavily focused on ensuring that customer interests are embedded throughout all areas of firms, and that all customers experience good – if not the best – outcomes. This is a matter of strategy and culture for management, much more than simply an issue of process and control. Yet we still see that too many firms are preoccupied with the defensive controls required to manage the regulatory risk (rather than customer detriment), and with seeking to comply with the narrowest interpretation of the rules.

The FCA is presenting much more than a new risk type. Boards and executive teams must grasp the scope and extent of the regulator's agenda, and the social and political expectations that drive it. If they do not, they run the risk of missing the strategic implications, and the potential for significant disruptions in the market, as the FCA's interventions start to change the nature of competition, and new business models evolve.

2. Insurer perspectives and industry reaction

The requirement to Treat Customers Fairly (TCF) was enshrined in the FSA's original Principles for Business with which all firms were required to comply. Over the years, the concept of treating customers fairly was enhanced and codified by the FSA, culminating in firms being required to demonstrate evidence that they had embedded "fairness" before 31st December 2008.

After a slow start, management teams invested heavily in responding to the regulator's agenda. However, looking back over the past decade, two things are clear:

1. The regulator's expectations have continuously evolved and increased, leading to new areas of regulatory focus and intervention.
2. At each stage, while progress has indeed been made, the industry's response has lagged behind the regulator's expectations.

“ The FCA will continue to focus on how firms are managed and structured so that every decision they make is in the best interests of their customers ”

FCA Risk Outlook 2013

Following the creation of the FCA in April 2013, we are seeing a new wave of conduct scrutiny. While the six consumer outcomes explaining what the FSA wanted TCF to achieve for consumers are still applicable, we view the FCA agenda as being substantially more than simply a few tweaks to the TCF regime.

The FCA has announced its intent to move to a new and more focused supervisory model. This entails:

- Moving from a reactive approach to a pre-emptive and judgement-based approach.
- Moving from dealing with symptoms to addressing underlying causes.
- Moving from an approach focused only on ensuring compliance with rules, to an approach that encourages firms to do the right thing in respect of their customers and the markets they operate in.

“ Our approach to risk will enable us to become more proactive and intervene earlier, focusing on the sources of detriment such as product design, governance and incentives ”

Martin Wheatley, FCA, Chief Executive

Against this background, the overwhelming conclusion from our survey is that there is a significant mismatch between FCA expectations and the views of many insurers with regard to:

1. The role of the regulator, and the level of regulatory intervention required to address any deficiencies in the market.
2. The practical implications of the new regulatory regime for firms, and the extent of the changes required to comply.
3. The level of preparedness and progress made by firms in adapting to the new regime.

These issues are explored on the following pages.

2.1. The role of the regulator

Up to the end of November 2013, the FCA has published its findings from seven thematic reviews which affect insurers.

Some insurers argue that this is too much, too soon from the FCA, and that increased regulation may result in a loss of innovation, greater financial exclusion and customer detriment. As evidence, they point to the impact of the Retail Distribution Review programme (RDR) and the resulting loss of access to financial advice for low and middle income earners. Some argue that as the regulatory burden rises in other areas of insurance (such as general insurance products) we will see a similar impact.

“*Conduct risk should be a “top 3” issue for all UK insurers*”

CEO, UK Life Insurer

The FCA’s objectives on competition and value for money represent a major area of concern for many insurers. Some worry that the FCA may potentially try to become a price regulator, and argue strongly that this is unlikely to improve market efficiency or lead to better customer outcomes.

The FCA has previously made its stance clear in this regard by saying explicitly that it does not want to become *a de jure* price regulator of insurance products.

However, recent UK Government proposals suggesting that the FCA should set a cap on the cost of payday loans have the potential to change the landscape. The FCA has genuine concerns over the value for money offered by some products on the market. Mobile phone insurance and legal expenses insurance have come under the spotlight, and pressure is mounting on the annuities area.

As the FCA takes action to improve competition (which we believe will mean much more transparency in how products perform for customers) and value for money, there is a risk of *de facto* price regulation of insurance products as judgements about product design and value play a greater role in the regulator’s supervision of firms. We also envisage more direct political pressure to regulate pricing in the insurance sector.

While the FCA’s conduct risk management approach has been distilled into a set of forward-looking priorities, clarity is still required in some areas. For example, how is value for money to be defined? What precisely are the responsibilities of insurers and distributors in ensuring good customer outcomes? While the regulator may provide further guidance in some areas, this is unlikely to be detailed or prescriptive. It will be up to each insurer to set out what “good conduct” means for their business. We believe this process needs to start with debate at the very top of the organisation about how it wishes to compete in the marketplace, and the relationship it wants to have with its customers, distributors and the regulator.

“*The current situation of “pseudo regulation of price” is very confusing for consumers and firms generally*”

CEO, UK General Insurer

2.2. Practical implications and extent of changes required

In addition to differing views on the extent of regulation and intervention required, we believe there is a disparity between the FCA and many insurers on the practical implications of the new conduct agenda, and on the extent of the changes that are going to be required. Many insurers view the changes to be relatively minor adjustments to their existing business and operating models.

“ *The main difference is that insurers have long recognised a duty of care to policyholders that does not seem to have a cultural equivalent in banking.* ”

CEO, UK Life Insurer

If we compare the results of our UK insurer survey to a similar survey we conducted with UK retail banks, we see that the banks are much more alert to the need for change and to the extent of changes required. Insurance company executives are keen to point out that the banks are very different to insurers, and that conduct risk is therefore less of an issue for insurers' customers than it is for banks' customers.

While we agree that insurers are very different to banks, we do not believe that insurers are going to get off lightly. Indeed, many executives we speak to are able to point out where current products, or the market, do not perform well for consumers. We therefore expect significant changes to insurer business and operating models will be required, albeit with different areas of focus from the banks.

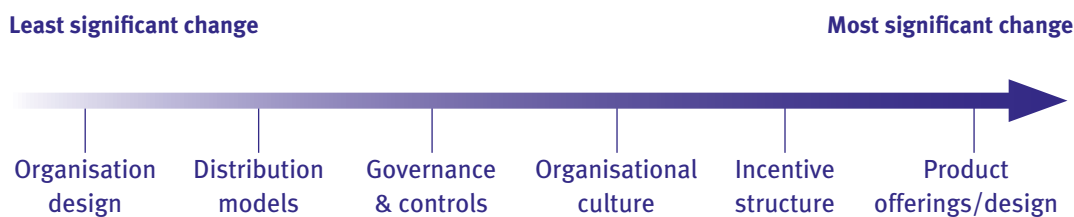
One of our survey questions asked insurance CEOs where they think the most significant impact will be felt across the overall insurance industry. The top three areas highlighted were:

1. Product offerings and design
2. Incentive structures (at point of sale)
3. Organisational culture.

“ *Important that regulation does not become a barrier to entry into markets and that it does not cause firms to withdraw from markets, reducing competition and customer choice.* ”

CEO, General Insurer

Figure 1. FCA and conduct impact on insurance industry – responses from survey recipients



On **product offerings and design**, many insurers have recognised the need to review their existing business and planned product launches to identify potential high risk products from a conduct perspective (those that pose most risk of customer detriment), and then take the appropriate action. Such reviews are expected to result in changes to product design (such as terms and conditions and policy exclusions), sales and targeting, support processes (such as claims management), and governance. In some cases, the review is likely to lead to the withdrawal of products, either through the firm’s choice, or with the active encouragement of the FCA. We have already witnessed significant changes in the banking sector, and are starting to see more signs of this in insurance too. In most cases, we feel insurance products could be adapted, and withdrawal will be unnecessary.

Insurers believe that **Incentive Structures** will also be affected, but that any changes will be mainly limited to front-line sales staff. Insurers will need to try to achieve a balance between meeting sales targets while also ensuring good customer outcomes. We have already started to see this in practice, with several insurers removing sales volume commissions for their front-line sales staff, and instead giving credit for quality of customer service and for ensuring that customers’ needs are met.

We agree that front-line sales incentive structures will need to be reviewed and aligned with good customer outcomes, although we do not consider that remuneration structures that include commission are inappropriate per se. However, they will need strong controls and different structures, such as the removal of commission payments if quality targets are not achieved.

We think that conduct (and customer-focused performance, more generally) could also play a much stronger role in the determination of executive bonuses. For example, while deferral of bonuses is now mandatory in banks, we note that it is not yet common practice for insurers. This could leave insurers exposed to the possibility that staff chase short-term profits without taking into account the risk of subsequent costs in regulatory fines or compensation.

Among the executives we interviewed, **organisational culture** was considered to be the third most significant area for change. This tallies with our own experience that culture and leadership have not yet received sufficient attention from firms seeking to meet the expectations of consumers and the regulator.

Insurers need to set out a tone from the top that moves beyond broad corporate aspirations, and is brought to life through leadership actions, decision making, business practices and standards, recruitment, rewards and clear communication to staff about what constitutes acceptable and unacceptable behaviour. Above all, the tone articulated by leaders to the rest of the organisation needs to be seen as authentic to staff (as well as to customers and the regulator) and has to be applied rigorously, or the unwritten ground rules that exist in today’s market will persist.

The FCA articulated this concept in a different way, asking companies to consider “should we” carry out a certain activity or behave in a certain way, as well as “could we”.

2.3. Level of preparedness and progress in adapting to the new regime

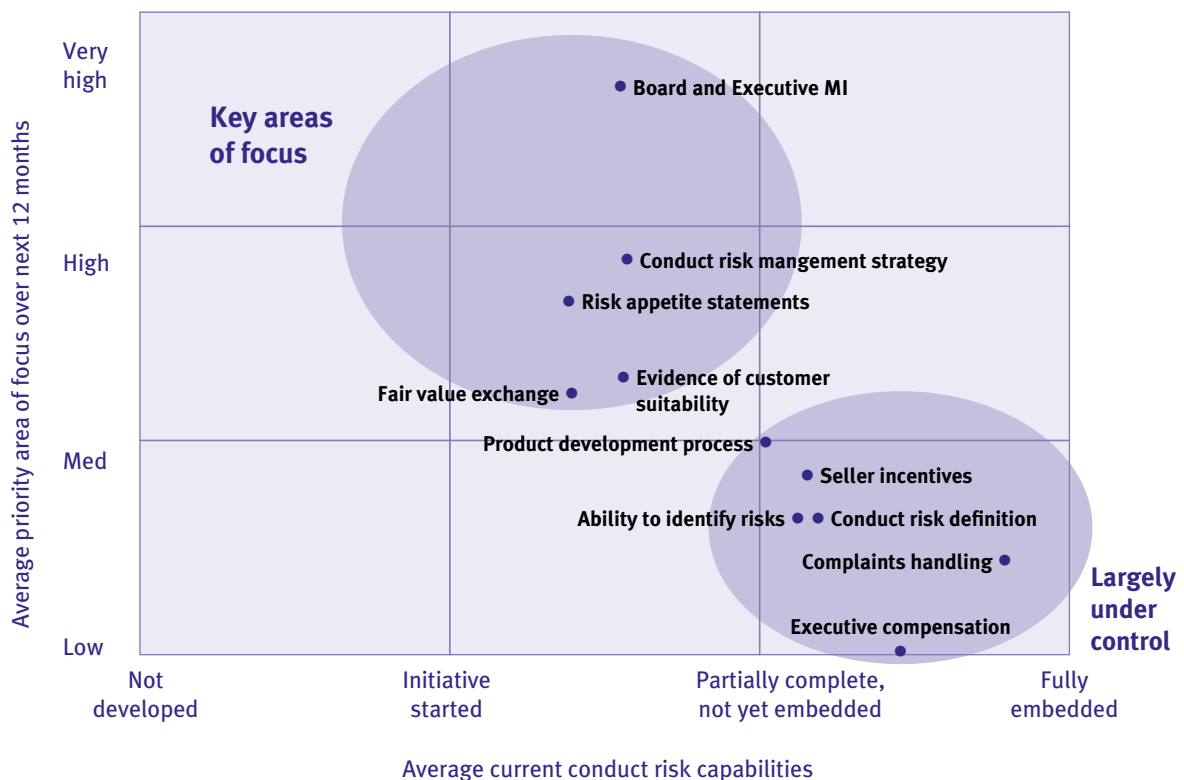
In our opinion, the regulator will expect firms to re-examine and, if required, realign their business and operating models, including strategy, systems and controls, skill sets, culture and incentives. The FCA has publicly stated that from the board right through to front line sales staff, firm behaviour, attitudes and motivations must change to embrace good conduct and ensure that customer experiences and outcomes meet expectations.

While some insurers are starting to take action, we believe that the insurance industry as a whole is still some way from defining and embedding a set of common good conduct practices. In our experience, many insurers do not yet have a clear view on what good conduct looks like for their organisation. Even in cases where they do, insurers sometimes face commercial challenges in achieving relevant goals, and feel that they cannot move forward by themselves in some areas. For example, pricing new and existing motor insurance customers at the same profit margin would result in massive first mover disadvantage.

Although the vast majority of insurers have already commenced preparations for the new regulatory environment, many still do not yet recognise the large-scale changes required to meet the FCA agenda on conduct risk. Our survey suggests that very few insurers currently have in place such a comprehensive approach to conduct. Few have introduced dedicated conduct risk programmes or teams to develop robust processes for identifying, monitoring and managing conduct risk. This is in contrast to their banking counterparts, which have invested heavily in aligning their business models and demonstrating evidence of good customer outcomes.

We asked insurers where they felt *their company* currently had good conduct risk capabilities, and where they needed to do the most work over the coming months. Figure 2, below, summarises the answers to this question.

Figure 2. Assessment of current conduct risk capabilities vs. priority area of focus for the next 12 months – responses from survey participants



According to the insurers we spoke to, the following areas were thought to be broadly under control and requiring limited additional focus:

- Executive compensation
- Complaints handling
- Definition of conduct risk
- Ability to identify conduct risks
- Seller incentives.

Perhaps surprisingly given what we see and hear from the FCA, almost all insurers in our survey felt that conduct risk management was almost fully embedded in **executive compensation**, and that this area did not require any additional focus. The FCA is very clear that good conduct starts with the “tone from the top”. Indeed, experience teaches us that one of the most effective tools for increasing executive focus on a particular area is to align incentives with that goal. Insurers should think carefully about how conduct influences executive compensation, ensuring that executives are rewarded for good conduct while also introducing other measures, such as the ability to claw back bonuses in future years for poor conduct.

Complaints handling was another area where insurers felt comfortable that they were broadly where they needed to be, and that little further attention was required. Two key reasons explain this finding. Firstly, insurers have already placed a strong focus on this area for a number of years under the TCF regime. Secondly, complaints and complaints handling performance is typically tracked as a Key Performance Indicator. While some firms’ complaints handling processes may not need to be overhauled (although Financial Ombudsman Service (FOS) uphold rates indicate that issues remain in some areas), insurers could reassess whether their complaints feedback processes are effective. Complaints can be a great early warning indicator of potential future conduct risks. Our sense is that many insurers do not do as much as they could to understand the root causes of complaints and remedy them.

On the **definition of conduct risks** and the **ability to identify conduct risks**, most insurers feel they have a good understanding of what conduct risk is, and have carried out some work to single out what they believe to be their most material conduct risks. However, in our view, the interpretation and focus of conduct risk is evolving. As we discuss in the following chapter, we believe that four areas will be prioritised in the next wave of conduct risk. From our research, many insurers are at present poorly prepared to respond to these future areas of focus, and have not adequately thought through where they stand on each issue.

Insurers recognise that **seller incentives** require careful realignment with good customer outcomes, although most feel that their firm has already tackled this issue. Some insurers are removing, or have removed, incentives for sales volume or value from the front line. This contrasts with the industry-wide view depicted in figure 1 which indicates that executives consider incentives to be an area that will require major change.

Insurers identified the following areas as those requiring most attention to address and embed fully:

- Developing **board and executive management** information specific to conduct risk.
- Develop a holistic **conduct risk management** strategy and approach.
- Update **risk appetite statements** to include more of a conduct risk focus, including the development of conduct risk appetite statements and appropriate integration with existing risk appetite.
- Demonstrate a **'fair value exchange'** between the insurer and the policyholder (we believe that this needs to be a higher priority than our research indicates it currently is).
- Demonstrate **evidence of customer suitability** and understanding (although some participants did not believe this was applicable to their business).

Almost all insurers stated that they need to do more work to improve the reporting of conduct-related measures in **board and executive management information**. We agree that management information does help in highlighting where there may be conduct-related issues. However, it is just one part of the solution. Conduct management information can assist in identifying where there are already conduct issues, but can also be forward-looking, helping to identify where potential conduct issues may emerge in the future.

Conduct risk management strategy includes defining what conduct risk is for the insurer, and their overall approach to managing conduct risk. Most insurers think of conduct risk as being embedded in everything they do as a business, cutting across all departments and processes. As such, it is less about having a single strategy on how to manage conduct risk, but more about embedding good conduct in the policies, processes, business practices and culture right across the organisation. Given the all-encompassing nature of conduct risk management, this is an area where many feel they have some work to do.

3. Moving beyond TCF

Important differences have already emerged between the FCA's current agenda and expectations and those under the FSA's TCF regime. When we consider the overall direction in which the market and regulation are moving, we see the future to be characterised by significantly more openness, transparency and accountability. This creates four emerging issues that may become particularly challenging for insurers. These are:

1. Following the rules is not enough. There will be a much greater focus on customers getting good **outcomes**, rather than on the actions taken by regulated entities to influence those outcomes.
2. Ultra-transparency means that all products and services will need to stand up to greater public scrutiny to prove that they offer **value for money**.
3. There will be more pressure to balance commercial decisions with satisfying demands for **equality** of access to insurance and for the removal of discrimination in pricing.
4. Companies will need to ensure that the potential advantages from rapid advances in technology and Big Data are not jeopardised by the inappropriate use and management of **customer data** and information.

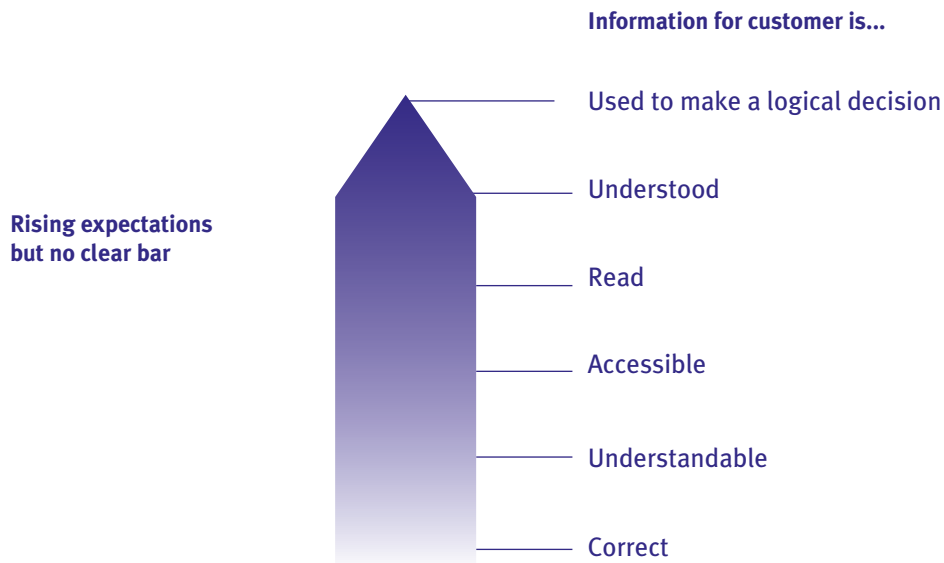
3.1. A focus on customer outcomes

The FCA has said very clearly that an important element of “good customer outcomes” is that products should be suitable for the relevant customers, who should in turn understand what they have bought. While no insurer is likely to dispute that this is the right aim, the key debate now concerns how far an individual insurer needs to go to ensure that the goal is realised. There are a number of interesting questions relating to this theme:

- What are the insurers' responsibilities in ensuring that its customers understand the products they are buying, and that these products are suitable?
- At what point does the customer have to take responsibility for ensuring that they understand the products, and that the products are suitable?
- What are the insurer's responsibilities when the product is being sold by a third-party distributor, and to what extent does the insurer need to ensure that distributors are also demonstrating good conduct and achieving good customer outcomes?
- To what extent do insurers have a duty to ensure good conduct with regard to competitors' customers (such as on the issue of referral fees)?

Many insurers will already test customer communications to ensure that they are understandable for the target audience, but is there a responsibility to check that the communication is being read, and that it is being used to make a reasonable decision?

Levels of responsibility for insurers to ensure customers get positive outcomes:



How many customers can be observed not making a logical decision, such as buying an annuity priced significantly higher than leading market rates, or continuing to automatically renew home insurance even though the premium is well above what could be obtained elsewhere, before an insurer should take some action? And what should this action be?

We cannot state what the right action will be – it will vary by specific product, channel and customer – but it will become increasingly unacceptable for insurers to observe poor customer outcomes and take no action, particularly when this occurs systematically.

The question of insurer responsibility for the conduct of distributors has been on the table for a long time, and insurer views in our survey ranged from “It’s not our job to regulate the IFAs and banks”, through to “It’s absolutely our responsibility to ensure that our distributors have the same conduct standards as we do – ultimately it’s our brand that is at risk if customers receive poor outcomes.”

We have seen examples of providers being more much proactive in monitoring distributors. Significantly for insurers, we are also seeing distributors being much more active in setting and monitoring conduct standards they expect from insurance product providers.

We believe that insurers will increasingly be expected to monitor, and be accountable for, distributors’ good customer outcomes. If the insurer, as product provider, is aware that many customers are not receiving good outcomes, they will be expected to take action. If they are not aware of a widespread failing by a distributor, they will be asked why they did not do more to check that good customer outcomes were being achieved.

The same focus on outcomes will apply to any situation where the insurer uses delegated authorities or outsourced service providers. As Clive Adamson, Director of Supervision at the FCA put it in a speech to the Insurance Institute of London in November 2013, “where insurers are outsourcing services to other companies acting on their behalf, they remain responsible for the actions of their agents.”

In a world focused on outcomes, a defence that “we did nothing wrong because we followed the rules” will be of little consequence if the outcome for customers was palpably poor.

3.2. Value for money

This was one of the most keenly debated topics in our interviews. There was a general consensus that products should be fairly priced and offer value for money. However, we also saw the less common opinion that if price and terms and conditions are fully explained, any price or margin is acceptable. According to this view, it is up to the customer to decide for themselves what represents value for money. For example, a price premium could be justified by the time saved in not shopping around, or by the peace of mind obtained through buying from a known brand.

When we explored how value for money could be assessed, there was much less clarity and no agreement about whether high prices or margins necessarily mean that the customer has got poor value for money.

In our view, the value for money issue is going to become increasingly important to the regulator. The FCA will seek to improve competition and transparency, and will intervene directly on behalf of consumers who are unable to determine if a policy represents a good deal.

Significantly, our research showed that this is not seen as bad news by all insurers. We saw a spectrum of attitudes on how firms should compete and behave in the market, including insurers who believe that both they and their customers will benefit from more transparency and from efforts to make value for money easier to assess. This conforms with the FCA's view that a more competitive market which treats its customers better is good for the industry.

It is therefore essential that insurers put themselves on the front foot by reviewing their products, and by making sure they can justify the value that products offer. In making this assessment, value for money is not just about price or insurer margin; it is unrealistic to say that a specific margin or claims level is unfair to customers. However, where profit is unusually high, this will need to be justified. This may be, for example, because it is a new product where the risk involves greater uncertainty, or that claims are volatile over the medium-to-long-term, meaning that a short-term assessment of margin is inappropriate.

In our opinion, each management team needs to develop clear guidance which will alert them to products that may offer poor value for money and where efficacy may need to be reassessed. This guidance could include factors such as:

- What value for money means for customers.
- The timeframe needed to make a realistic assessment of the product's risk and margin.
- The distribution of premiums and fees to each player in the value chain – distributor payments and commission, insurer profit, and claims payouts.
- Policy conditions that reduce the value of the product, such as high excesses, exclusions, triggers for premium increases.
- The impact of “hidden charges” that increase the total cost of the product for customers.
- The impact on total cost and value when selling bundled products and add-ons to improve returns on low-margin core products.

It is apparent that many other factors influence the perception of value for money. These may include the brand of the provider and distributor, the question of whether the product meets the customer's needs, or the service level customers receive both during and after the sale, and whether they could have obtained an identical (or nearly identical) product at a significantly lower cost. There is also a simple question of whether one company's product is cheaper because it offers better value for money, or because it has misunderstood the risk.

Society is moving to one of ultra-transparency and accountability. Unless a firm is confident it can stand up to public scrutiny, it is at risk. The test for insurers is to ask how the regulator, media and customers would react if all the details of a product were fully transparent and in the public domain: charges, commissions, claims levels, margin, and so on. If the answer to this question feels uncomfortable, then action is probably required.

3.3. Equality

In future, we consider that there will be increasing pressure on insurers to ensure that there is greater "equality" between customers. To date, this pressure has arguably been exerted more through political channels (and subsequent applications through the judicial route) than through regulatory interventions, such as gender neutral pricing. We expect overall pressure to continue.

While insurers can accept that some customer groups are priced out of the market or are otherwise disadvantaged due to the nature of their risk, this logic is unattractive from the perspective of public policy, where insurance is viewed as a social good. And as we have seen in relation to gender-neutral pricing and flood insurance, government will directly intervene in the market under the guise of promoting equality.

Given this trend, insurers need to consider whether current approaches to pricing and distribution are at risk from regulators or legislators who are keen to ensure equality and remove any sense that certain customer groups are being disadvantaged.

One area which may need to be reconsidered is the pricing of new versus existing customers. While almost all insurers we speak to say that they would like to reward loyal customers, it is common practice across many product lines to offer better rates to new customers than to existing customers. This has been insurers' response to market and consumer behaviour, and they appear fearful of a massive first-mover disadvantage should they try to change tack. Meanwhile, collective action is constrained by competition issues.

We do not believe that regulators should prohibit differential pricing as a way of insurers growing market share (or rewarding loyalty). Nor should all customers be required to be offered an equal price; lower-risk customers should reasonably expect to pay less.

In our view, it should be acceptable for an insurer to take a small, or negative, margin in the early years of a customer relationship in the expectation of a higher margin over time. However, there is clearly a spectrum between recovering initial investment in acquiring a customer and deliberately exploiting customer inertia over the longer term of a contract. We suggest that insurers need to be clear about where their own risk appetite lies. Factors they may want to consider include:

- The extent to which the margin profile is transparent to customers at the point of acquisition (e.g. by advertising an explicit first year discount).
- The profile of customer margins over time (for example, whether margins continue to rise after the point at which the original investment has been recouped).
- The magnitude of the gap between the price offered to seasoned customers and the new business price they would be offered if they shopped afresh.
- The extent to which vulnerable subgroups are offered value for money (e.g. the elderly, and other groups less able to shop around).

There are other practices that, although less obvious, could also be reviewed in order to determine how to ensure they are appropriate from both an equality and conduct risk perspective. For example, if a customer calls a motor insurer, they might have a one in a hundred chance of receiving a quote that is 5% higher than normal, and a one in a hundred chance of receiving a quote that is 5% lower than normal. This is a common approach to testing price elasticity, but it is clearly unequal. Whether this should be a source of concern is not yet clear, and represents an example of the difficult judgements that insurers need to make.

Many people in the banking sector are saying that it is time to return to what they term “old-fashioned” banking. Insurers may wish to consider what this may mean for them, and the extent to which the original purpose of insurance – the shared pooling of risk – is still relevant and how to balance this with the need for people to pay a fair premium commensurate with the risk they contribute to the pool.

Each insurer will need to adjust their own comfort level, and ensure that an appropriate balance is achieved between individual underwriting, pooling of customers and the principle of access to insurance for all sections of society. Even where decisions make sense in the world of underwriting and commercial logic, management needs to consider what challenges may emerge in the name of equality.

3.4. Use of customer data and information

The advance of technology and Big Data opens up innovation opportunities for insurers in product design, pricing, customer targeting, servicing and claims management. However, even while operating within the boundaries of the law, there are still questions about the limits of what is acceptable and unacceptable use of customer data. There is both a regulatory and reputational risk for insurers if Big Data opportunities are exploited faster than customers want.

To ensure the advances in technology are not jeopardised by inappropriate sourcing, usage and management of data, insurers need to develop clear guidance and principles on the use of customer information.

For example, it is common practice in the annuity market to ask customers about their health and lifestyle in order to determine whether they are eligible for an enhanced annuity. This is acceptable if the customer voluntarily provides the information directly to the insurer as part of the quotation process, but is it acceptable for the insurer to obtain this information through other sources? Is it appropriate for a supermarket to use loyalty card data on cigarette purchases to be used in pricing annuities for their customers? What if an insurer can see from the customer's Facebook page that they smoke?

One could argue that there is no problem if the use of this information is delivering a better outcome for the customer (for example, in the form of a better annuity rate, or to detect fraud), and the information is available within the public domain (and a Facebook posting is arguably putting information in the public domain). But what if the insurer uses information that is legally available, but is obtained without customers' explicit consent, in order to price a protection product, and this additional information results in a higher price for the customer or cover being declined?

Another interesting area is the use of behavioural data. Some insurers are experimenting with using information about how the customer behaves on their website as an input into the quotations given. For example, they may take into account the products which customers view, and how many different combinations of product features they try out. A customer who tries several alternative amounts for an excess on an online motor insurance policy quotation form is considered to be more sensitive to price than someone who just requests a quote with the standard excess.

Other examples of this dilemma include whether it is fair to load the premium for one customer if they happen to share the same address as someone on a fraud database.

Insurers need to be confident that not only are they operating within the letter and spirit of all relevant laws and regulations, but that, as they capture and make use of new sources of customer data, they are happy to defend what they do to customers when asked. The ABI guide on telematics may be a useful example of how these concerns can be addressed in an open way.

As well as considering how they use customer data, insurers also need to think about how they store and manage it. For example,

- If relying on information not knowingly or directly provided by the customer, how to ensure that it is verified?
- How is data kept up to date so that only the most recent information about a customer is used to make a decision?
- How is data kept secure so that it is not lost or stolen?

As the amount of available personal data being captured and stored grows, the challenge increases. We expect to see the regulator being much more vigilant, and less tolerant, in this area.

To date, most of the debate has been dictated by what is technologically possible and commercially useful. The potential for significant reputational and regulatory risk associated with customer data means that more discussion is required about what is acceptable.

4. The response

As each wave of consumer protection regulation has been brought forward, the industry has lagged behind the regulator's expectations. This remains the case despite the fact that insurers have made significant progress, devoting considerable attention to ensuring good customer outcomes.

It is clear, however, that any firms which believe that they can continue to take a narrow compliance approach will find it increasingly difficult to provide the evidence required by the FCA. This may leave them exposed to significant regulatory and reputational damage. Ultimately, some of the changes envisaged by the FCA (resulting from an increasingly consumerist society, and an interventionist political body) may make some business models obsolete. If they ever were, conduct risk and consumer protection certainly no longer represent a box-ticking compliance exercise.

In order to manage and embed conduct and customer-related risk across the business, insurers must ensure they have a clear and well-defined approach which is aligned to good conduct and the FCA's broader requirements. This must originate from board level, and then be clearly communicated to internal and external stakeholders.

We believe that a strong conduct risk approach embedded into the organisation is a critical success factor in the longer-term viability of insurance businesses. In our survey, many insurers cited other industries where they believe certain companies have demonstrated better conduct than many insurers. The examples most frequently provided were John Lewis and Amazon.com in the retail sector, and Virgin Atlantic in the airline industry. The executives we spoke to believed that these companies possess one common trait – they have put customers at the heart of their strategy and business model, and this has been an important factor in their profitability and growth. Insurers were also keen to point out that there are also plenty of examples of poor conduct in both of these industries too!

Some insurers have already been taking bold action over the last year or so, for example by removing all sales incentives for front-line general insurance staff, while others have taken more of a “wait and see” approach. Now that expectations on good conduct are becoming clearer, and regulatory scrutiny is increasing, these firms will have to catch up. Through our work on conduct risk, we have come to view five steps as critical in achieving lasting progress in this area:

1. Define your conduct risk appetite, and obtain senior stakeholder buy-in.
2. Perform a conduct risk diagnostic to identify changes required.
3. Strengthen tools, processes and controls.
4. Realign the business model with good customer outcomes.
5. Reinforce through leadership behaviour, culture, training and incentives.

Step 1.

Define your conduct risk appetite and obtain senior stakeholder buy-in

The conduct issue is not black and white. Each insurer needs to decide its own appetite or tolerance for conduct risk and communicate its conclusions broadly across the firm in order to influence behaviour.

In defining risk appetite, management needs to define how far their firm should go in terms of both knowing, and being able to demonstrate evidence that:

- Customers understand what they are buying.
- Products are suitable for the customer buying them.
- Customers are receiving acceptable levels of service.

Insurers also need to define what conduct risk appetite means in practice. For example:

- To what extent should all customers be offered the lowest possible price?
- How can loyal customers be rewarded?
- To what extent does conduct risk appetite extend to include the behaviour of your distributors?
- To what extent does it include the outcomes of other insurers' customers (such as in relation to referral fees in motor insurance)?

These are discussions that should be led by the board.

Once the conduct risk appetite has been defined, strong senior stakeholder buy-in for the risk appetite has to be obtained. Such stakeholders also need to accept the need to change to align with the stated appetite. It is important that senior stakeholders recognise the importance of getting conduct risk right.

They must also understand the potential implications of getting it wrong, with possible fines and compensation payments, as well as potential longer-term damage from the impact on the company's reputation. Insurers that have been the most successful at obtaining senior stakeholder support have tended to be those where board members firmly believe that ensuring their business model is aligned with achieving good customer outcomes is not only the right thing to do, but is also commercially the best thing to do in the medium-to-longer term.

Accountabilities need to be agreed for conduct risk management and oversight, balancing the responsibilities of business units and risk and compliance departments. Our survey showed that those insurers which had made most progress in implementing a conduct risk strategy had involved both entities in a balanced way. Firms may wish to identify an executive to take formal responsibility. Indeed, some firms have appointed a Head of Conduct Risk, or formally included conduct risk within the mandate of an existing executive, such as the Regulatory Risk Director. Responsibilities for managing conduct risk on an everyday basis can then be integrated into existing governance structures, always ensuring significant front-line involvement and accountability.

Step 2.

Perform a conduct risk ‘diagnostic’ to identify changes required

In the short term, firms should have a credible and effective response for conduct risk in place as a matter of priority. Some institutions’ instinctive response has been to view conduct risk just as yet another sales process compliance programme. However, we feel that this response fails to understand the scale of change that is required across their value chains, as the industry moves into the new Conduct era.

In our work, we regularly carry out risk identification using a “follow-the-money” approach, exposing potential areas of customer detriment by looking at those areas of the insurer’s business where significant revenues and profits are generated. This has proved to be a useful approach, and conduct regulators such as the UK FCA are looking to follow suit. It is important to note, of course, that strong profitability does not necessarily indicate that there is a conduct issue. It merely serves as an indicator (one of many) that there may be conduct issues that should be investigated further.

There are a number of potential contributing factors to poor customer conduct. It may be helpful for insurers to go through these to help them identify potential conduct issues within their portfolio. Key factors can include:

- Complexity of product, and the relative sophistication of the customer.
- Price transparency and ease of switching.
- Whether the policy is the actively sought product or an ancillary, add-on or policy.
- Universality of the product and size of the suitable market.
- Irreversibility: the ease with which a customer and the insurer can withdraw from the contract without negative impact.
- The quantum of the downside risk for the customer and insurer as a result of poor conduct.
- Importance of the product to the insurer’s overall business.
- Level of commission being paid.
- Level of competition within the product line, and profitability.

In addition to achieving clarity on the customer segments and product classes at risk, six major processes along the value chain need to be reviewed:

1. **Product development and governance:** Integration of conduct risk criteria into new product approval and governance processes, including the definition of positive outcomes and corresponding metrics, as well as ongoing monitoring of the product’s performance and indicators of emerging risks.
2. **Customer segmentation:** Upgrading of segmentation and profiling tools to cover needs, risk appetite, financial experience, eligibility and loss tolerance.
3. **Customer proposition:** Increasing the detail and sophistication of product/customer matching, and aligning commercial terms more closely to the concept of a positive outcome.

4. **Sales:** Formalisation and upgrade of sales force standards and training, linking qualification levels to product sales authority, both internally and at distributors. Upgrading of sales process documentation to demonstrate evidence of suitability. Development of outcome testing procedures, such as mystery shopping.
5. **Post sales, including claims and complaints:** Active monitoring of product performance to identify customer detriment. Upgrading of customer reporting to incorporate risk content, and increasing dynamic reporting frequency to reflect risk levels.

Much of the above relates to front-line tools and processes, and indeed the onus should be on the front line to ensure its alignment with the principles of good conduct of business. On the one hand, this is good news to those institutions aspiring to greater efficiency in risk and compliance. On the other hand, such front-line activity requires oversight and monitoring. For this to be effective, firms should ensure that conduct risk becomes part of their overall risk taxonomy, and is thus fully integrated into risk identification, assessment and management processes.

Oversight requires information that can support management decision-making. Such information should be based on metrics which focus on customer outcomes as well as on inputs to the conduct risk management process. As boards increasingly seek oversight of conduct risk performance, we have found that indicators such as mystery shopping results, customer outcome testing, profitability metrics, customer satisfaction and advocacy, and product performance statistics can all be useful in substantiating the content of reports to board level.

In carrying out the conduct risk diagnostic, insurers must quantify and prioritise the gaps identified, for example by employing a measure of customer value detriment. They should also classify each gap into one of three categories:

- Gaps that should be addressed as soon as possible, due to a short-term risk of FCA action against the firm, significant consumer detriment or reputational damage.
- Other gaps that the insurer is able to address by acting alone, despite the free-rider risk and potential for first mover disadvantage.
- Gaps that can only be addressed if other insurers do so at the same time (although if the industry waits too long for a collective response, it may find that it has a less attractive solution forced upon it).

Having agreed the thrust of the approach and its principal components, firms can then detail the initiatives that they will pursue to embed good conduct of business into their products and processes. The ensuing work will involve two elements. Firstly, tools, processes and controls are likely to need strengthening to provide assurance and evidence that those outcomes are being achieved. Secondly, business models will need to be reviewed to ensure they are fundamentally aligned with the concept of ensuring good customer outcomes.

Case study – A life insurer has implemented a dedicated conduct programme

A life insurer has established a dedicated conduct risk programme with a clear objective to identify and reduce any poor customer outcomes across their business. The programme is sponsored by the CEO and involves the 1st and 2nd lines of the business working closely together. The programme has strong senior stakeholder support and has been up and running for the last 6 months.

The Insurer broadly followed a five step process:

1. Defined conduct risk strategy and what ‘good’ looks like for the organisation, including a clear definition of a ‘customer detriment’ measure which considers customer outcomes rather than just business processes.
2. Established a conduct programme, including a formal programme structure, dedicated 1st and 2nd line resources and a clear set of objectives and measures of success
3. Carried out a review across the business to identify the most material areas where customers – generally as a result of their behaviour or understanding – may not be getting what informed professionals might deem appropriate outcomes.
4. For each area, identified the levers required to reduce the quantum of customer detriment, developed a business case for making the changes required to address the issue and set clear targets for reducing this over the next three years.
5. Implemented the identified changes, tracked the impact on the value of customer detriment and now regularly report on progress to the board.

By way of example, within its annuities business the Insurer estimated that 20% by value of its Defined Contribution pension customer flows were purchasing a standard annuity, when a proportion would have been eligible to purchase an enhanced annuity which the firm does not offer. Whilst the annuity rates offered were very good when measured against conventional rates in the market for the Open Market Option, and disclosures in customer communications are fully compliant, effectively a small proportion of these customers were making a potentially uninformed choice and this was leading to customer detriment. The firm estimate that the value of the loss to impacted customers was greater than £5m per annum.

The levers for addressing this were identified and a project has been set up to close the gap in a phased manner. The benefits included within the business case include elements for both the company and the customer.

The CEO feels very strongly (and has the board’s support) that the vast majority of these issues can be addressed in ways that are ‘Net Present Value (NPV) positive’ or at least close to NPV neutral in terms of profits to the insurer over the medium term. So, not only is finding ways of improving customer outcomes the right thing to do, they also believe it is commercially attractive to do it.

Step 3.

Strengthen tools, processes and controls

Insurers need to develop their management information and develop key monitoring metrics to be able to demonstrate evidence of strong customer service and good customer outcomes. Some insurers have introduced a “conduct risk tolerance score”, which is linked to their stated conduct risk appetite and is regularly reported to the board. The score includes metrics related to features such as product characteristics, customer experience, customer outcomes, sales incentives and staff capabilities. While the existence of this metric in itself will not necessarily improve conduct, it can be a useful tool in prompting debate on conduct among the executive team and the board.

“*Insurers need to find business models that really reward customer loyalty*”

CEO, Composite Insurer

Step 4.

Realign business model with good customer outcomes

The more defensive moves outlined above are the necessary actions required to avoid fines, litigation and reduce customer complaints. But a control framework is designed to curtail activity in areas deemed risky, not suggest ways in which to sustain the revenue streams from those activities. There is thus a risk that focusing on defensive moves leaves a strategic vacuum at a time when insurers can expect to see significant disruptions in the market with Conduct of Business principles becoming fully embedded.

Insurers should therefore prepare for the strategic implications of a business model more closely aligned with conduct risk concerns. We believe that these strategic implications will be felt in at least three areas:

- Ensuring suitability and appropriate targeting.
- Delivering value for money.
- Responding to a growing agenda for equality.
- Harnessing technological innovation at a pace acceptable to consumers.

It is likely that a business model more closely aligned with good Conduct of Business will involve a simpler and more transparently priced product range, and an arguably fairer distribution of insurers' costs and revenues across their customer base as a result. Such changes can result in significant shifts of market share between firms which are well prepared for change and have relevant plans in place (such as through using customer analytics to gain a better understanding of their needs), and firms which are merely reactive, remaining resistant to change before delivering an uncoordinated response.

One specific example concerns general insurers. Currently the strategy of most general insurers involves offering lower premiums to new customers, assuming they can make profits on this business in later years as premiums increase for those customers who remain.

Likewise, it is claimed that many annuity customers fail to get a good deal as they do not shop around, and providers knowingly exploit this inertia.

In both these, and other, examples, there must be a risk that these practices will not be sustainable, and therefore that business models based on these practices will not be sustainable.

We believe that boards, and specifically non-executive directors, have a role to play in challenging existing models and understanding the sensitivity of the business to significant changes to the status quo. For example, what would happen if price differentials between new and existing customers were projected to shrink significantly or disappear within the next five years? Or if there was a significant increase in consumers taking advantage of the open market and shopping around for the best annuity solution? Would the board be willing to continue to write business in the same way? Would the insurer's operating model be cost-effective?

Step 5.

Reinforce through leadership behaviour, culture, training and incentives

Conduct risk management will fail if the tone at the top and the messages given to staff through hiring, training and performance management do not reinforce the strategic positioning on conduct risk.

Organisations need to form a realistic view of the culture in their organisation, and seek to understand the unwritten ground rules and relationships which influence the way decisions are taken throughout the organisation. A helpful starting point can be a “cultural thermometer” test to understand the underlying culture of the firm, comprising surveys, interviews and focus groups which involve senior management, the front line, the middle and back office and clients.

A series of actions can then be identified relating to leadership development, incentives, training and development, recruitment and rewards, tools and processes, all seeking to embed and reinforce the desired cultural values. These actions will help to ensure that people do what is right even in situations that are not foreseen by policy and process, thereby reducing exposure to conduct risk. They will also serve to keep overall risk and control spending in check.

In the sales arena, incentives are one of the most critical determinants of behaviour and have been identified as a significant contributor to past failings. We continue to find through our work that incentives, in their simplest form, can lead to good staff behaviours, encouraging staff to understand customer needs and to direct customers to suitable products. For example, conduct could be managed by only giving credit for high-quality sales where customer needs and suitability have been clearly demonstrated, and by ensuring rewards are based on a balanced set of metrics (for example, through meeting needs, and displaying good service and good colleague behaviours).

Notwithstanding the above, however, it is the senior leaders of the firm and how they behave, act, make decisions and communicate that will have the most impact on creating and reinforcing the culture of the firm.

5. The insurance industry working together

While each individual insurer must develop its own response to the market conditions created by the FCA, there is scope for collective action to help create the right regulation, and help ensure good customer outcomes.

Over the years, collective action, led by the Association of British Insurers (ABI), has sought to push through improvements to customer outcomes. For example, the Raising Standards programme and the Customer Impact Scheme, which each enjoyed broad, if not full, participation from insurers, were right for their time, and could point to real improvements in their wake.

We consider that industry-driven collective action therefore remains beneficial in the following areas:

1. Scrutinising proposed regulation to ensure that market reforms are not against the interests of competition and customers, for example through identifying the potential losers as well as the potential winners from regulatory proposals.
2. Creating Codes of Conduct that act as a guide to ensure that insurers deliver good customer outcomes.
3. Providing a forum to discuss how to address issues which insurers will not tackle on their own due to the risk of first-mover disadvantage.

We acknowledge that the ABI is a member organisation and not an accrediting body or supervisor and that Competition Law limits collective action in sensitive areas such as duel pricing. However, the FCA has clearly set out that it will intervene to improve the operation of the market, and it is likely that any response outlined and promoted by the regulator would be less welcome to the industry than something it was able to design itself.

6. Conclusion

Our discussions with CEOs and senior executives from across the insurance industry were open and informative. They revealed that most insurers have made significant investments to improve customer outcomes, but also that insurers do not generally share the same views as the FCA about the extent of customer detriment and the scale of change required. Indeed, there is a real concern in the industry that too much regulation could reduce competition and innovation to the detriment of consumers.

It is important for insurers to identify the significant trends of openness, transparency and accountability that will shape the nature of conduct regulation. Each insurer, with the active involvement of their board, will need to decide what impact these trends may have on their business model, how they want to respond and their appetite for regulatory and reputational risk.

In our experience, this exercise requires a structured approach to assess the viability of current business models, and to identify what business practices and operations need to change. All of this must be supported by a strong focus on ensuring the firm's leaders and culture set the right tone for the business.

Insurers who consider that conduct risk is no more than an evolution of TCF are likely to find themselves on the wrong side of the FCA. They will also fall behind as other insurers develop business models, products and cultures more attuned to today's market.

Appendix: List of participating firms

We are grateful to the following firms for their participating in our research.

- Aegon UK
- Ageas UK
- Allianz UK
- Amlin
- Aviva UK & Ireland GI
- Aviva UK & Ireland Life
- AXA UK
- BUPA
- Catlin
- Direct Line Group
- Friends Life
- Hiscox
- Legal and General
- LV GI
- LV Life
- Partnership Assurance
- Prudential UK and Europe
- ReAssure
- Royal London Group
- Standard Life
- Zurich UK GI
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