Address by Helena Mitchell, Head of Consumer Protection: Supervision Division to the Society of Actuaries in Ireland: ERM Forum, 10 May 2016

"A regulatory perspective on consumer risk"

Good afternoon. I'd like to thank the Society of Actuaries for inviting me here today.

I have been asked to give you a regulatory perspective on consumer risk, so to do so, I will take a few minutes to describe what we in the Central Bank see as 'conduct' and 'consumer' risk. I will then give you an overview of our 2016 consumer risk outlook, with a particular focus on the importance of embedding a strong consumer-focused culture and robust product governance processes. Before I finish and hand over to Michael, I will also explain our expectations of firms in terms of enhancing or developing fit-for-purpose consumer risk management frameworks and our plans to commence a program of supervisory assessments of firms' progress in doing so, commencing later this year.

What is conduct and consumer risk?

From a regulatory and supervisory perspective, there has been a much increased focus on conduct and consumer risk since the onset of the financial crisis, however, as concepts, both have been around for many years before that, enshrined in the principle of acting in the best interests of your customers and the integrity of the market - a principle which is at the heart of the Central Bank's consumer protection codes since the mid-2000s.

The struggle to define the concept is reflected in the fact that there are no standard or universal definitions of conduct or consumer risk as they relate to financial services. But that said, there are common threads running through the various definitions used by regulatory bodies, which are all underpinned by the expectation that firms will balance their objective to maximise shareholder return with a full understanding and appreciation of their customers' needs and experience.

In 2011, the Central Bank defined 'conduct risk' in the context of our risk-based supervisory framework (which you will all know as 'PRISM') as "*the risk the firm poses to its customers through its direct interaction with them*."

In early 2015, we defined 'consumer risk' in our first published Consumer Protection Outlook Report, which builds on - and broadens - the definition of conduct risk. Essentially, we define consumer risk as anything that would threaten our objective that regulated firms treat consumers fairly and with dignity and respect.

This is intentionally a very broad definition – recognising that consumer risk can stem from a firm's culture, including its governance and other structures; its products and services; its systems and processes; or from the behaviour of individuals at any level within the firm – and this also includes the structures and behaviours of a firm's appointed agents and outsourced partners. Consumer risk can also be driven by factors other than a firm's internal structures and our definition therefore recognises the impact of the prevailing operating environment, as well as consumers' own knowledge, behaviour and skills. The latter driver of consumer risk is particularly relevant because of the inherent information imbalance that exists between financial services firms and their consumers. From a regulatory perspective, therefore, we expect firms to fully understand and appreciate their consumers' needs and their financial capability to be in a position to provide them with products or services that are suitable to their short and long-term needs and that match their risk appetites.

In February this year, we published our second Consumer Protection Outlook Report, which gives our assessment of current and emerging risks to our consumer protection objectives.

Although we have published these risks, and although I'm here speaking to you about them today, managing these risks is clearly not just a matter for the Central Bank. Each regulated firm has a responsibility to its customers to consider - and where appropriate to manage - the risks we have identified in our risk outlook, in the context of the firm's business strategies, structures and activities. And this should not replace, but rather it should be in addition to each firm's own horizon-scanning of current and emerging consumer risks.

Consumer Risk Outlook 2016

A number of key risks to our consumer protection objectives are highlighted in the 2016 Outlook Report, the greatest of these being the absence of a consumer-focused culture in regulated firms and poor product oversight and governance. I'll come back to these risks in more detail later, but firstly I'd like to briefly mention three further risks which are particularly relevant to the insurance sector.

Operating environment

The first relates to consumer risks that may arise from the current operating environment. As you are all very aware, the current operating environment is challenging for some insurers and in this context, where a firm is planning any changes to its strategy or to its business model or where it is considering cost-cutting measures, we expect firms to fully assess the potential impact on consumers prior to implementing any such changes.

> For example, firms must ensure that any cost-cutting measures are not at the expense of basic customer service, especially in the field of insurance claims. Consumers will have already paid for that service through their premium and therefore have a legitimate expectation that their claims will be processed fairly and fully and that they will be processed by employees who have the relevant experience to do so.

Building on previous supervisory work in this area, we will continue to actively monitor claims handling in 2016, with an initial focus on motor insurance.

Service Delivery

Another key risk to consumer protection comes in the form of service delivery. We recognise that, in financial services as elsewhere, business models and methods of service provision are changing.

We are not suggesting that these new service delivery methods are inherently problematic, nor do we have any desire to stifle potentially positive effects of innovation and competition. On the contrary, we acknowledge that emerging technologies can provide real benefits and opportunities for consumers – but only once firms have thoroughly identified any associated risks to consumer protection and manage these risks accordingly. This includes ensuring that consumers are properly informed of the costs and benefits of the service method and also ensuring that services are reliable, safe and secure. For example, with the introduction of automated or *robo-advice* in the insurance sector, firms must be able to stand over the integrity and reliability of the underlying algorithms used - and upon which consumers will be basing important financial decisions.

IT Resilience and Data Security

We have also called out a key risk in relation to IT resilience and data security in our 2016 risk outlook. Our Deputy Governor, Cyril Roux, addressed the Society on cybersecurity and cyber risk in September last and Michael will also address you on the topic later today. So, other than to say that we see cyber risk as a permanent feature of the business and regulatory landscape, which has implications for consumers as well as for firms, I won't discuss this risk in any further detail today.

I'd like to focus in more detail now on what we see as the two greatest risks to our consumer protection objectives – and I'll discuss them in reverse order (ii) poor product governance and (i) the absence of a consumer-focussed culture.

Poor product oversight & governance

It is well documented that there is a very strong relationship between product governance and consumer risk and there are many public examples of poor product governance that will be familiar to you all, including the sale of payment protection insurance in Ireland and the UK. This has resulted in some €70 million in redress in Ireland and recent reports in the UK suggest that the cost of the PPI scandal there has reached £37bn, which is reported to be four times the bill for the London Olympics.

Why is product oversight and governance so important in the context of financial services? - Unlike many other 'consumer goods', financial products and services are intangible, so while insurance products provide peace of mind and other benefits to consumers and to society more broadly, they are not visible in the way that other physical consumer goods are. Because consumers cannot see or touch the product they are purchasing, it is difficult for them to assess and to understand whether or not it meets their current needs and whether or not it will continue to do so in the future. This makes it all the more important for the professionals, who do understand the products and who are selling the products to ensure that they meet their consumers' needs and expectations.

Over the past two years, we have drawn specific and sustained attention to the importance of product oversight and governance in our Consumer Protection Outlook Reports. All regulated firms have been clearly advised of the Central Bank's expectation that they must be able to demonstrate that their products are fit for purpose – this means that firms must move away from a heavy reliance on legalistic terms and conditions, which contain clauses that are either unfair or just simply impossible for consumers to understand.

To elaborate on this point a little, I will briefly mention two themed inspections we conducted in the insurance sector in 2015:

Sale of pension annuities

As part of our focus on the sale of long-term retail products, we chose the sale of pension annuities as an area for examination in 2015. We did so in the knowledge that the purchase of a pension annuity is a complex transaction for many consumers and also that it is a one-off purchase, which can have a major impact on a consumer's income in retirement. Our starting point was an expectation that insurers are acting in a clear and transparent manner, and that they are making the purchase of an annuity as straightforward as possible for the consumer. During the inspections, we reviewed insurers' product literature and we also examined their engagement with consumers during the sales process.

Based on our findings, providers have been required to enhance certain disclosures and also to enhance elements of their sales processes to ensure that products are fully understood by consumers and are suitable for their individual needs.

Renewal of health insurance

A second example of the risks associated with transparency relates to the sale of health insurance policies. In March, we published the findings from our recent inspection of the health insurance market, which assessed how consumers are being treated at the crucial time of policy renewal. We supported this supervisory work by conducting parallel consumer research.

We found that consumers find it difficult to compare health insurance policies; that renewal notices issued to consumers are not highlighting important information; and that providers should be doing more to ensure that they are providing the most suitable policy, particularly when consumers are purchasing on-line.

Again, based on our findings, we have required health insurance providers to enhance the content and presentation of their policy renewal notices and we are also following up with three providers regarding their processes for gathering information for website quotations and the range of policies offered through their websites. The sale of health insurance will continue to feature on our supervisory work plan.

Other regulatory bodies have also responded to risks associated with poor product governance. EIOPA is increasing its focus on consumer protection and taking a leading role in promoting transparency, simplicity and fairness in the market for retail products and services across the EU. You will probably be aware that EIOPA published its preparatory guidelines on product oversight and governance for insurers in April – which are due to take effect from 3 January 2017. The guidelines are an essential element of the new regulatory requirements under the Insurance Distribution Directive, which was published in the official Journal on 2 February 2016 and must now be transposed to National law by member states by 23 February 2018.

Gabriel Bernardino, Chairman of EIOPA, said:

"*These Guidelines further minimise the risks of consumer detriment*
and mis-selling of insurance products.
We need to ensure that products are designed with clear customer needs in mind
but also that these products are being sold to the right customers.
Insurers and intermediaries need to place consumers
at the heart of their business strategies.
The tone of this change has to come from the top."

In principle, I'd like to think that you all agree with those sentiments and that you will build them in to your thinking in terms of how you do approach your own work.

Absence of a consumer-focused culture

Last, but certainly not least in terms of our risk outlook, we see the absence of a consumer-focused culture as the most significant and on-going threat to our consumer protection objectives. Why? - It should go without saying that where firms do not embed a culture of fair treatment of consumers within their governance, risk management and business processes, there is a significantly higher risk of poor outcomes for consumers.

Consumer risk must therefore be looked at through the lens of corporate culture and not purely as an operational or a regulatory issue - which we have too often seen translated as '*something for the compliance guys to worry about'*. Good conduct is not just tick-box compliance with the letter of the law, it is a culture that inherently recognises the long-term interests of consumers.

Globally, regulators including ourselves have introduced many rules and regulations to seek to influence a cultural shift in financial services firms – including consumer protection codes, corporate governance codes, fitness and probity requirements, minimum competency rules, remuneration guidelines – and the list goes on. While these rules can undoubtedly help to guide an employee's decision-making, I think that all regulators would readily agree that rules, in and of themselves, will never be enough to prevent consumer detriment.

Although the board of each of your firms is responsible for setting the right tone, this in itself will be wholly ineffective if the board does not also satisfy itself that a strong consumer-focused culture is deeply-rooted and sustained throughout the entire firm - and among those appointed to sell products and services on the firm's behalf. And remember, the *right tone from the middle* is a critical success factor here as it is a strong signal of what is actually happening on the ground.

> I'm sure most of you have heard the saying "culture eats strategy for breakfast". I think it is particularly relevant in the context of today's discussion because I firmly believe that it is each employee's actual experiences, rather than what the firm intends or wants them to experience that drives how they make decisions. Let me give you an example of what I mean - infamously at this stage, Enron's mission statement declared

"We treat others as we would like to be treated ourselves....

We do not tolerate abusive or disrespectful treatment.

Ruthlessness, callousness and arrogance don't belong here."

> I'm sure most of you have read some of the many reports and articles which document how well some of Enron's employees lived up to that particular statement!

There are plenty of other well publicised scandals that demonstrate the power of an organisation's culture, including the Volkswagen diesel emissions' scandal and closer to home, the recent Libor and Forex scandals in the UK.

Getting the foundations right

So, the moral of the story is that, to be effective, the cultural shift must come from within your own firms and must be underpinned with strong internal support structures. This will involve a critical appraisal of internal processes, including incentive schemes, which by their very nature and intent seek to drive the behaviour of individuals who are engaging with consumers and also reflect the inherent culture within a firm.

The Central Bank has taken a lead in this area by publishing Guidelines on Variable Remuneration for Sales Staff in 2014 and we are continuing our supervisory work in this area to ensure that firms have fully adopted the guidelines in practice and in principle. We have also commenced an examination of the risks and benefits of commission payments to intermediaries. Our first step will be to publish a discussion paper on this topic in order to seek input from interested parties and then to decide next steps.

And of course, this particular structural driver of consumer risk is not exclusive to how firms are incentivising sales staff and appointed agents. Insurers should look at the performance and bonus structures of all staff across all levels of the organisation to ensure that their performance and remuneration models do not conflict with consumers' best interests.

To sum up my views on culture and its potential to drive consumer risk, it's worth pointing out that although this is often considered to be a qualitative risk, there are plenty of well publicised examples - some of which I've mentioned earlier - which go some way towards quantifying the impact that poor culture can have on the bottom line and indeed on the ability of some firms, or individuals within the firms, to continue in business at all.

Priority – Consumer Risk Management Frameworks

With all that in mind, now is a good time to mention our plans for monitoring how firms are embedding fit-for-purpose consumer risk management frameworks, which is a key element of our supervisory strategy to influence a more positive consumer-focused culture in the firms we regulate.

In February 2015, we communicated to all regulated firms that they need to introduce or to enhance their internal consumer risk management frameworks. In order to do so, firms must consider how they will:

- Identify consumer risks, which will be specific to each firm, because, as I mentioned a few times now, these risks can stem from the firm's culture, business model, strategy, internal structures or systems;
- Articulate the consumer risk strategy and appetite – setting out the aggregate level and types of risk that the firm is willing to accept, avoid etc. in order to achieve its strategic objectives;
- Design and implement appropriate consumer risk architecture – including governance and oversight, systems, processes and policies (this includes recruitment, performance management, remuneration, incentive and training policies);

- Ensure all employees have a comprehensive understanding of what the firm's risk management policies and processes mean to them in their daily roles – this includes defining and communicating roles and accountabilities for consumer risk management to all employees. Employees must also be trained to accurately identify consumer risks and know how to respond appropriately;
- Take steps to ensure the consumer risk appetite statement is a living document. By this I mean that consumer risk management must be built in to the firm's systems and structures, and employees must value and truly believe in it, so that it translates in to fair outcomes for consumers in practice; and
- Develop appropriate metrics and methodologies to continuously monitor and manage consumer risk and be able to demonstrate to the Central Bank that they are using this MI effectively. This will be a challenge for firms, and I think it is an area where actuarial support can add real value.

As I mentioned earlier, the Central Bank is increasingly challenging boards not just to set the **'consumer tone'** from the top, but to own it, commit to it and deliver on it. To do this, firms must be able to demonstrate that they are outcome-focussed and not just process-driven and that they are looking through the eye of the consumer as well as the eye of the shareholder.

We are currently enhancing our own supervisory model, with a view to testing and measuring firms' progress in implementing fit-for-purpose consumer risk frameworks, commencing later this year - with a particular focus on culture, governance (including product oversight) and internal controls. This supervisory work will be in addition to our regular program of thematic inspections, which examine how firms are selling their products and services in practice.

How does all this fit with Solvency II?

Before I finish, I'll pre-empt a question that some of you might have - how does all this fit with insurers' extensive requirements under Solvency II? To my mind, it fits hand in glove because prudential and consumer protection supervision pursue a common goal in protecting the interests of consumers. Indeed, many of the recent developments in financial services' supervision have focused on the need for regulated firms to embed a sound risk culture. To achieve this, firms must have risk management frameworks that are designed to adequately identify, monitor and mitigate all relevant classes of risk, whether prudential or consumer-related – or, as is often the case, both.

In a recent key note speech by Gabriel Bernardino on the implementation of Solvency II, he referred to the new governance requirements as *"a paradigm shift towards a more consumer-centric culture"* adding *"There is a need to better integrate conduct of business concerns in the institutional governance arrangements in order to ensure that companies reliably place the interest of their customers at the heart of their business*."

So if you take only one thing from today, I'd like it to be a full recognition that current and emerging *consumer risks*, like all other risks in the insurance industry, must be identified and managed effectively. And as you are meeting the challenges of enhancing your enterprise risk management frameworks in line with Solvency II, head on, now is the time to ensure that consumer risk is fully considered in that process.

To do this, firms must understand the sources and impact of consumer risk and their place within the enterprise risk management framework. As I have mentioned more than once now, consumer risk can stem from a firm's culture, business model, strategy, governance and other structures and from external drivers, so these risks are not purely 'operational' or 'regulatory' in nature as many firms and regulators have traditionally considered them to be.

For example, unfair or misleading business practices can be symptoms of insufficient control over distribution channels, ineffective governance or other inadequate internal controls. Similarly, where existing risk management frameworks exclusively classify conduct and consumer risks under 'regulatory risk', then there is high potential for these risks to be managed using a 'tick box' approach to achieve minimum compliance, rather than a focus on the fair treatment of customers.

Conclusion

Although I was asked to give you a regulatory perspective on consumer risk today, I hope my presentation also points to the importance of considering consumer risk from other perspectives –

Poor business practices can and do impact on the lives of large numbers of consumers. And persistent poor outcomes for consumers will lead to adverse consequences for insurers and the sector more broadly, including the significant cost of putting things right, reputational damage, loss of trust among key stakeholders and a decline in business.

So, effectively managing consumer risk has wider social and economic benefits that go far beyond the regulatory framework. In the simplest terms then, it is in firms' interests; employees' interests; consumers' interests; shareholders' interests; regulators' interests; and the interests of the wider public that we work together to ***get it right for consumers***.

Thank you