ACTUARIAL ASSOCIATION OF EUROPE

ASSOCIATION ACTUARIELLE EUROPÉENNE

4 PLACE DU SAMEDI

B-1000 BRUSSELS, BELGIUM

TEL: (+32) 22 17 01 21 FAX: (+32) 27 92 46 48

E-MAIL: info@actuary.eu
WEB: www.actuary.eu

CONDUCT RISK INDICATORS

Actuarial Association of Europe Position Paper

January 2016

Contents

1. Purpose of Document

The purpose of this document is to identify (i) areas of potential consumer detriment arising as a result of the conduct of insurance companies (manufacturers and distributors) and (ii) indicators which may suggest a potential source of consumer detriment.

This document has been prepared by the consumer protection task force of the Actuarial Association of Europe to help EIOPA and other interested bodies develop relevant indicators of Conduct Risk.

Although the paper only refers to insurance, including insurance-related savings products, some of these indicators might have wider applicability, for instance to banking and other financial products.

Consumer-related risks identified may not be the sole responsibility of insurers (manufacturers) but may also be impacted by distributors of insurance products such as independent brokers/intermediaries or sales forces acting as agents.

This document provides an overview of risks to consumers and links identified risks with potential indicators. The purpose of these indicators, which are at an aggregate (company/market/product) level rather than at the level of individual policies, is to act as a flag for areas or products where a more in depth analysis should be carried out. In addition, the document identifies some behavioural sources of consumer detriment and groups of consumers who may be at particular risk.

2. Risks to which Consumers are Exposed

Before proposing potential risk indicators, it is useful to define the main areas of potential consumer detriment. One way to approach this is to use the main risks to which consumers are exposed when purchasing a financial product, as follows:

A. Products may not be developed and marketed in a way that pays due regard to the interests of customers;

B. Customers may not be provided with clear information before, during and after the point of sale;

C. Customers may be sold products which are not appropriate to their needs;

D. Customers may receive poor quality advice;

E. Customer complaints and disputes may not be dealt with in a fair manner;

F. The privacy of information obtained from customers may not be correctly protected; and

G. The ongoing reasonable expectations of customers may not be met, e.g. customers may perceive that they have received poor long term value for money.

It is possible to classify risk indicators according to these risks. It is also possible to characterise each risk indicator according to its timing in relation to the realisation of the risk concerned, i.e. “leading”, “coincident” or “lagging”. Where indicators are leading, observing the indicators over a period of time may give prior notice of the emergence of risk. Coincident indicators may provide evidence of emerging risk(s) while the risk(s) are emerging. For lagging indicators, it is only possible to observe the emergence of the risk after the event.

In general, the indicators that will be of greatest ongoing interest will be the leading or coincident indicators. Nevertheless, prompt identification through lagging indicators can help resolve an issue before large numbers of consumers are impacted.

3. Indicators of Potential Conduct Risk

Quantitative metrics can provide an indication of where there is a greater risk of conduct related issues. They can however only draw attention to areas where further investigation and analysis could usefully be carried out, and will never be prima facia evidence of conduct issues. For most measures, there can be a number of influences which could lead to variation(s) from expectation. Institutional conduct can be one of these but should not automatically be assumed to be responsible.

Most indicators covered here are not systematically captured through regulatory returns and may require bespoke review or data collection by supervisors. Indicators can be collected at a company level and at a market or a sectoral level. One of the potential pitfalls of such bespoke collection is inconsistency of reporting as between companies. Inconsistencies could easily lead to misleading comparisons and inappropriate conclusions. Careful planning and parameter specification is required to avoid this.

For our purposes, characteristics of each indicator have been addressed under three different categories, i.e.

- Data availability:
  Summarises availability and accessibility of a given indicator. Some indicators will inevitably be easier to measure and collect than others. It is important to note that indicators can be misleading if calculated at an aggregate level and should therefore be measured and collected on a sufficiently granular level to ensure consistency across the entities being measured. For example, comparison between life business persistency levels is only really valid for individual product types. Comparison between life and non-life businesses is not valid across most of the measures discussed.
  These indicators should therefore be collected/calculated for homogeneous groups to ensure the validity of benchmarking and comparisons between companies, markets and products.

- Consumer Risk:
  Defines the risks, labelled in accordance with the risk types identified in section 2, which could be measured/identified by each indicator. Insights provided by indicators may be to one or a number of the risks to which consumers are potentially exposed.

- Timing:

  This characteristic defines any time availability constraints of a risk indicator for a given company, market or product. Each indicator can be defined as Leading, Coincident or Lagging.

Table 1 below provides a list of potential indicators. The detailed specification of measures appropriate to each of the indicators may vary according to the relevant market and availability of data. Some sample indicator measures are shown in Section 4.

A number of important observations relating to the identified risk indicators is shown below.

- Observation of the indicators listed may point to potential sources of consumer detriment. Deviating indicators do not in themselves mean that any company, market or product which is flagged by one or more indicators is the subject of consumer detriment but draw attention to areas where further analysis could usefully be carried out.

- A company, product or market which is not flagged by indicators may still give rise to consumer detriment.

- The indicators listed below are generic indicators which should be available, though most likely to differing levels of granularity and with differences in technical composition, from each EU market. National supervisors may also wish to include some additional indicators, which may help them to identify potential sources of consumer detriment which are specifically applicable to their markets.

- The indicators shown are not exhaustive and successful ongoing generation of each of these indicators should not be considered to address all possible sources of consumer detriment.

- The indicators are in general relevant to both life and non-life business though they may in some cases be more relevant to one or other and any specific relevance is mentioned in Table 1.

Table 1: Potential Risk Indicators

Ref	Indicator	Data availability	Consumer Risk	Timing	Comments
1	**Commission levels**	May not be publicly available at the level of detail required. May require bespoke enquiry of companies.	A, C, D	Leading	High commission levels may lead to misleading and aggressive selling practices. For investment/pension products, initial and ongoing commission payments should be considered separately. Can be difficult to compare broker/intermediary and sales force payments. Need also to consider non-product specific payments, e.g. "overrides".
2	**Cost Cutting**	May be identified through public announcements by insurers or from analysis of regulatory returns. Such activity may not itself be publicly disclosed and may be observed through trend analysis of cost ratios.	F, G	Leading	Significant cuts in costs may impact service or operational resilience levels to the detriment of consumers.
3	**Impact of charges**	In some markets, suitable measures may form part of the existing disclosure regime. Need measure of aggregate impact of expenses.	A, B, C, D	Leading/Coincident	A key indicator of the value of the product to the end consumer for investment/pension products.
4	**Illustration growth rate**	Regulations will apply in many markets but there may be areas of discretion.	A, B, C, D, G	Leading/Coincident	Insurers may illustrate policy returns to customers that are unlikely to be achieved in practice. Insurers may also, by concentrating on quantifiable indication of return, fail to identify potential variability of return.

5	**Level of product bundling**	May require bespoke enquiry of companies.	A, C, D	Leading/Coincident	Indicator of risk of misselling, i.e. customers being sold unnecessary covers as supplement to required covers.
6	**Claims Ratios (Non-Life business)**	May not be available at a sufficiently granular level. May require bespoke enquiry of companies.	A, C	Coincident/Lagging	Very low levels of claims relative to premiums may indicate value or conduct issues. Low claims ratios may suggest a high volume of refused claims, which may indicate misselling or bad product wording.
7	**Consistency of range of possible outcomes with consumer risk appetite**	Not generally available. Likely to require bespoke enquiry of companies.	A, C, D	Coincident	May indicate inappropriate characteristics of product for target market.
8	**Growth (premium amounts or market share)**	Available historically at a high level, though available data may lack the granularity required to identify problem growth areas. Supervisors may have access to business plans and future growth plans.	A, C, D	Coincident/Lagging	High growth (historic and/or planned) could be an indicator of aggressive selling practices or excessive price discounting.
9	**Complaints**	May be some public disclosure of complaints data. In a number of markets, the financial ombudsman is an important source of trends in complaints not resolved by firms. May require bespoke enquiry of companies.	A, B, C, D, E, F, G	Coincident/Lagging	High levels of complaints or protracted complaint resolution times may indicate conduct issues. Emerging themes should be investigated promptly.

10	**Profit**	Not generally publicly disclosed at a sufficiently granular level. Likely to require bespoke enquiry of companies.	A, C, G	Coincident/Lagging	Sustained abnormally high profitability, either on in force or new business, could indicate products which offer poor value to consumers. Conversely, low or negative profitability could be an indicator of unsustainable pricing practices.
11	**Policy size by contract type**	Some data available from regulatory returns.	C	Lagging	Differences across companies or markets could be indicators of inappropriate pricing or superfluous covers.
12	**Deviation of returns to consumer for different groups of similar contracts**	Likely to require bespoke enquiry of companies.	G	Lagging	Deviations could indicate inappropriate investment policy or inequitable treatment as between groups of policyholders.
13	**Lapses/Surrenders**	Likely to require bespoke enquiry of companies.	A, B, C, D, E, G	Lagging	High absolute or relative levels may indicate conduct issues.

4. Indicator Measures

This section suggests potential quantitative measures for some of the indicators in Table 1. These are preliminary and high level suggestions and further analysis and discussion would be required to establish a sustainable, fit for purpose regime.

For some indicators, different measures will be applicable for different types of product reflecting different product characteristics, e.g. life and non-life insurance, investment and protection products.

Commission levels
Percentage of Gross Written Premium. This measure should include allowance for elements such as clawback, override commission and renewal commissions.

Cost cutting
Expense ratio (management expenses as a percentage of premium). This measure should be refined to reflect characteristics of different business types, e.g. non-life and life.

Impact of charges
Reduction in yield due to aggregate charges for investment/pension product. The measure should reflect intra-term policy values on termination as well as maturity values.

Claims Ratios
Accident/Underwriting year loss ratio.

Growth
Change in Gross Written Premium or change in market share in given line of business.

Complaints
Number of complaints.

Profit
New business value as percentage of premium for life/investment/pension products.
Combined operating ratio for non-life business.
In exploring apparent profit issues, the levels of capital required to be held for different products and, if possible, returns on capital employed, will be an important factor to consider.

Lapses/surrenders
Percentage of premium or policies exposed to renewal which is not renewed. Allowance should be made for different product characteristics in making comparisons.

In general, trends in the indicators shown may be more reliable than individual measures and judgements on the basis of limited numbers of measures should be avoided.

To avoid excessively detailed reporting, it may be appropriate to collect indicators at a relatively high level with deviations acting as a trigger for more detailed examination.

5. Identifying the behaviours underlying consumer detriment

In this paper, we recognise two main type of behaviour from which consumer detriment may crystallise, as follows:

- Companies taking advantage (knowingly or unknowingly) of clients who are vulnerable at certain stages of their lives, or targeting certain groups of clients who may not have complete information to make clear judgements in relation to products being sold to them.
- Companies operating in a way which puts all, or certain groups, of their clients at a disadvantage.

Vulnerable clients have a higher intrinsic risk of consumer detriment due to their own set of characteristics. Most people are likely to be vulnerable consumers at some point in their lives, and will as a consequence face a higher risk of detriment at that time.

Examples of potentially vulnerable clients include those who are:

- using financial products or services for the first time;
- operating without the benefit of advice, e.g. in the case of direct sales via the Internet;
- in adverse or stressful circumstances, and prone as a consequence to make less rational decisions;
- unduly swayed by marketing and advertising materials or approaches;
- low in language, literacy and/or numeracy skills;
- living in a high risk area prone to risks such as flooding, theft or burglary;
- physically or geographically isolated;
- in need of products which require high levels of specialist knowledge;
- advanced in age; or
- acquiring insurance products which are linked to other products and/or purchases.

Identification of vulnerable customers will be a valuable step in identifying suitable behaviours and examples of consumer detriment.

Examples of companies acting in a way which puts consumers at a disadvantage include:

- technical and financial results being allocated between insurance portfolios and generations in a way which may not be appropriate (most likely to be addressed by indicator 12 in Table 1 above);
- limiting communications, thereby preventing consumers from identifying or addressing issues of detriment;
- failing to communicate clearly;
- providing poor customer service, perhaps by focusing on new customers at the expense of existing;
- making changes to policy terms and conditions with no or limited notice;
- failing to constructively address customer complaints.

Indicators listed in Table 1 may address some of these aspects but cannot be exhaustive and, to fully address the risk of consumer detriment, must be supplemented by ongoing market vigilance.