LMA Conduct Audit Training Conference 2016

9 February 2016

Building a better working world

Market overview: achieving good customer outcomes

Introductions

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- Director in EY's Financial Services Risk practice.
- He joined EY in 2010 and is based in the London office. Prior to that David worked at the Financial Services Authority and the UK Treasury in a range of insurance policy and supervision roles.
- Experienced regulatory advisory insurance professional with experience across conduct and prudential risks
- Has led numerous independent reviews and s.166's for insurers and brokers covering governance frameworks and risk management systems including controlled functions of Risk, Compliance and Internal Audit

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- Manager in EY's Financial Services Risk practice.
- Joined EY in 2014. Prior to that Anthony worked for a large national retail insurer in Governance, Risk and Compliance.
- Experienced regulatory advisory insurance professional focussed largely on conduct risk in the London Market.
- Seconded to Lloyd's Conduct Standards Assurance Team until January 2016. Responsible for performing reviews of managing agents against the Conduct Minimum Standards (MS11) and the day to day supervision of managing agent conduct.
- Regular author of articles for EY's insurance publications across EMEA.

What is conduct risk?

- Conduct risk is the risk that good customer outcomes are not achieved:

In the context of Lloyd's, 'Conduct Risk' means the risk that a managing agent (or its agents) will fail to pay due regard to the interests of Lloyd's customers or will fail to treat them fairly at all times

What do we mean by ‘customer’?

- **When looking at conduct risk, the term ‘customer’ can be applied to anyone covered or entitled to benefit under an insurance policy. This can include:**

Policyholders

Named Beneficiaries

Third Party Claimants

Third Party Service Providers

Agents of Policyholders and Claimants

- **Where there are long or complex distribution chains, consider the impact on the *underlying customer***

What do we mean by ‘customer type’?

- **A customer’s size and sophistication is a key consideration when determining whether an outcome is fair or not. Consider the different needs and reasonable expectations of the following:**

  - Individual
  - Small Business/ Micro-enterprise
  - Medium/Large Enterprise
  - Large Global Corporation
  - Insurer/Managing Agent/Broker

- **Policies sold to individuals and SMEs on a retail basis are likely to present a higher conduct risk**

The regulatory evolution of conduct risk

- The regulator's approach to conduct risk has evolved:

Rules → **Principles** → **Risks**

- The FCA's approach to conduct regulation is outcome based
- The FCA have found a broad range of areas that they believe can lead to poor outcomes for customers:

Business model and strategy	**Complaints handling**	**Product development and governance**	**Business continuity**
Remuneration and reward	**Financial promotions**	**Conflicts of interest**	**Management and oversight of agents**

Does conduct risk vary by jurisdiction?

The basic principle of conduct – achieving good customer outcomes – applies irrespective of the local laws and regulations …
… and wherever Lloyd's policies are sold

“We continue to believe that a cultural shift within firms to celebrating good conduct that places consumer interests and market integrity at the heart of the financial sector will benefit all stakeholders.”

– FCA Business Plan 2015/16

Why is Conduct important to the market?

- Recognition that there are more individuals and small business/micro-enterprises that are Lloyd's and London Market policyholders than previously understood
- Insurers wanting to maximise their customer proposition to provide products which better meet the needs of their retail and SME customers
- Insurers need to fully understand the conduct risks they are underwriting through the sale and distribution of retail and SME products
- Increased regulatory focus on wholesale markets and the use of delegated authority arrangements
- Thematic Reviews on Delegated Authority, Commercial Claims, Broker Conflicts of Interest, General Insurance Add-ons, and Mobile Phone Insurance
- FCA and PRA Enforcement Activity:
  - Stonebridge – £8.4mn
  - Millburn Insurance – £2.9mn

What does this mean for audits of coverholders and TPAs?

The importance of DA audits

- As we have seen, product design, delegated underwriting, claims, complaints and the availability and use of management information are key areas of potential conduct risk for insurers
- Third-party audits of coverholders and TPAs are an essential tool for managing agents in identifying and managing conduct risks in their agents
- The audit profession is evolving post-financial crisis
- There is some good practice – but managing agents, Lloyd's and the FCA are all looking for more value-add from the audits…

… which is why we are here today

Breakout 1: Value chain and customer outcomes

The Value Chain and Customer Outcomes

- **Learning objective:** to understand the risks posed to customer outcomes throughout the business value chain
- **Activity:** You will be allocated a part of the value chain to discuss in groups. You will be given time to answer the question below for **your stage of the value chain** after which each group will nominate a spokesperson to share their findings with the wider audience.

Q **Consider all of the activities in your allocated stage of the value chain. What are the customer risks and why are these important?**

Table Allocation

- **Table 1** – ‘Service’ and ‘Claims’
- **Table 2** – ‘Marketing and Advertising’ and ‘Sales’
- **Table 3** – ‘Product Development’
- **Table 4** – ‘Service’ and ‘Complaints’
- **Table 5** – ‘Marketing and Advertising’ and ‘Sales’
- **Table 6** – ‘Product Development’
- **Table 7** – ‘Service’ and ‘Complaints’
- **Table 8** – ‘Service’ and ‘Claims’

Coffee break

Forward looking attributes

Introductions

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- Executive Director in EY's Financial Services Risk practice.
- EY Insurance Internal Audit leader based in UK.
- Experienced internal audit professional with Chief Audit Executive, co-source and advisory roles in Insurance.
- Leads EY's Internal Audit relationship with global insurance group.
- Has led numerous independent reviews of Insurance Internal Audit functions in the last ten years.
- Author of various EY Insurance Internal Audit publications.

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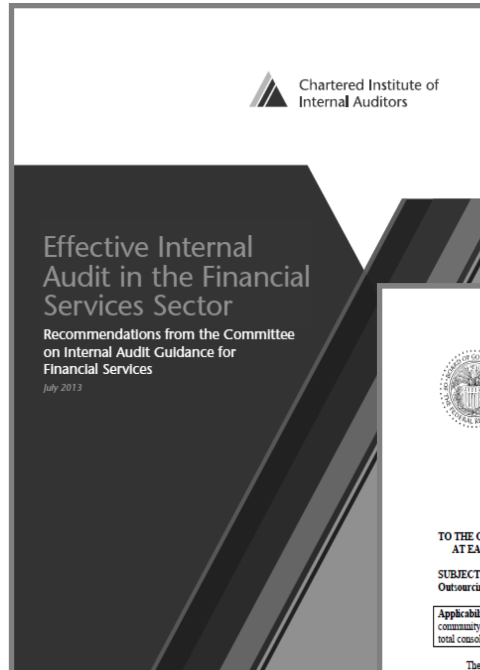
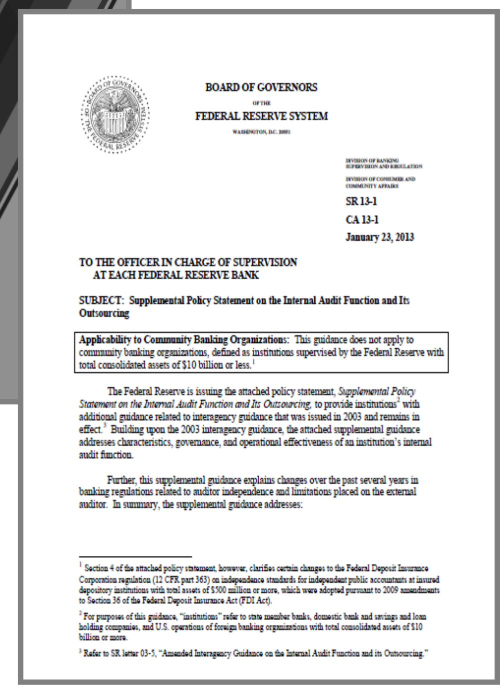
- Senior Manager in EY's Financial Services Risk practice.
- Experienced internal audit professional, focused on insurance but experience across Financial Services.
- Manages EY's Internal Audit relationship with global life insurance group.
- Author of many of EY's Internal Audit eLearning modules.
- Delivered Internal Audit methodology change programmes at numerous insurers globally.
- Performed assessments of Internal Audit functions at various Financial Services firms in the last two years.

What is driving reform?

Setting the scene

- Professional audit practices have evolved in recent years in response to the global financial crisis.
- This has prompted further evolution of audit arrangements across the Financial Services industry.
- Furthermore, G20 regulators are now expecting higher standards from Financial Services firms.





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DIVISION OF BANKING SUPERVISION AND REGULATION

DIVISION OF CONSUMER AND COMMUNITY AFFAIRS

SR 13-1
CA 13-1
January 23, 2013

TO THE OFFICER IN CHARGE OF SUPERVISION AT EACH FEDERAL RESERVE BANK

SUBJECT: Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing

Applicability to Community Banking Organizations: This guidance does not apply to community banking organizations, defined as institutions supervised by the Federal Reserve with total consolidated assets of $10 billion or less.[1]

The Federal Reserve is issuing the attached policy statement, *Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing,* to provide institutions[2] with additional guidance related to interagency guidance that was issued in 2003 and remains in effect.[3] Building upon the 2003 interagency guidance, the attached supplemental guidance addresses characteristics, governance, and operational effectiveness of an institution's internal audit function.

Further, this supplemental guidance explains changes over the past several years in banking regulations related to auditor independence and limitations placed on the external auditor. In summary, the supplemental guidance addresses:

[1] Section 4 of the attached policy statement, however, clarifies certain changes to the Federal Deposit Insurance Corporation regulation (12 CFR part 363) on independence standards for independent public accountants at insured depository institutions with total assets of $500 million or more, which were adopted pursuant to 2009 amendments to Section 36 of the Federal Deposit Insurance Act (FDI Act).

[2] For purposes of this guidance, "institutions" refer to state member banks, domestic bank and savings and loan holding companies, and U.S. operations of foreign banking organizations with total consolidated assets of $10 billion or more.

[3] Refer to SR letter 03-5, "Amended Interagency Guidance on the Internal Audit Function and its Outsourcing."

Application to Managing Agents

- While many of the interventions are directly aimed at Internal Audit functions, the principles of effective audit apply to all audit professionals.
- Lloyd's Managing Agents expectations are raising as a result of these guidance notes and this will filter across the market. They are also working on making improvements of their own to their DA frameworks.
- The scope of Delegated Authority audits is undergoing change. The underlying approaches and work performed to effectively deliver the scope is also changing.
- The Lloyds Minimum Standards state with regards to an Audit of a Distributor after appointment with regard to Conduct Risk:

> *"The output of the audit should generally be a written report that provides the managing agent with an **objective and evidence based** assessment of the Distributor with regard to Conduct Risk. Where the Distributor has sold Products with a high Product Risk, the report should also include observations on the corporate culture of the Distributor with regard to Conduct Risk."*
>
> ***– Lloyd's Conduct Minimum Standards (MS11) CR15.10***

What is the main outcome?

The purpose of reform

A **step change** in the effectiveness of Audit functions.

Involvement

- Fully aware of and appropriately engaged in all significant business issues.

Influence

- Credible and persuasive, providing reliable assessments.

Impact

- Demonstrably able to effect improvement.

How is the profession reacting?

Stakeholders have driven change

Stronger contributions

- **Reporting on identified thematic issues and potential trends.**
- **Gauging the setting of/adherence to risk appetite.**
- **Evaluating the integrity shown in dealings with customers.**
- **Appropriateness of outcomes driven by governance/processes.**

- These principles apply regardless of the scale of the audit being undertaken

How can we deliver messages that add greater value?

Firmly linking the ‘case for change’ to business objectives … … helping to make the business better, and steer clear of trouble

Asking ‘why?’, ‘why?’, and ‘why?’ again to source the underlying root cause

Thinking more closely about risk/control behaviours and mind-sets exhibited by people

Joining the dots to draw together information into impactful broad themes for key stakeholders

Recap

Key messages …

- The climate has changed for audit professionals
- Stakeholders are expecting, and willing to embrace, a heightened sense of contribution from Audit Functions/Auditors
- Lloyd's Conduct Minimum Standards (MS11) –

*"The output of the audit should generally be a written report that provides the managing agent with an **objective and evidence based** assessment of the Distributor with regard to Conduct Risk. Where the Distributor has sold Products with a high Product Risk, the report should also include observations on the corporate culture of the Distributor with regard to Conduct Risk."*

– Lloyd's Conduct Minimum Standards (MS11) CR15.10

- A recognised contribution is notably enhanced by value-adding reporting
- This in turn, requires some changes to auditing techniques

Breakout 2: Getting the answers and adding value

Getting the answers and adding value

- **Learning objective:** to understand how to apply principles of good audit practice to assessing the risk of poor customer outcomes.
- **Activity:** In the same groups from Breakout 1, you will be given time to discuss and note your answer to the question below after which each group will nominate a spokesperson to share their findings with the wider audience.

Q

Considering **all aspects** of the audit lifecycle, how can **audit messages add value** when reviewing **Conduct Risk**, and what work do audit need to do to deliver these messages?

Your discussion and responses should ignore issues such as scope and resources.

The principles behind value adding messages are recapped below:

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A sking 'why?', 'why?', and 'why?' again to source the underlying root cause

T hinking more closely about risk/control behaviours and mind-sets exhibited by people

J oining the dots to draw together information into impactful broad themes for key stakeholders

EY

Coffee break

Q&A and Stakeholder view

Closing remarks

Thank you

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ED None

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