PROTECT

Legal and Regulatory Review

MAY 2019

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TRAINING

“VALUE”


SUPER SAVE
SAVE 90%
SAVE 80%
SAVE 70%
SAVE 60%
SAVE 50%
SAVE 40%
SAVE 30%
SAVE 20%
SAVE 10%

The latest in a line of regulatory buzz words

- Treating Customers Fairly
- Principles-based regulation
- Good consumer outcomes
- Conduct Risk
- Customers' best interests

Each is accompanied by . . .

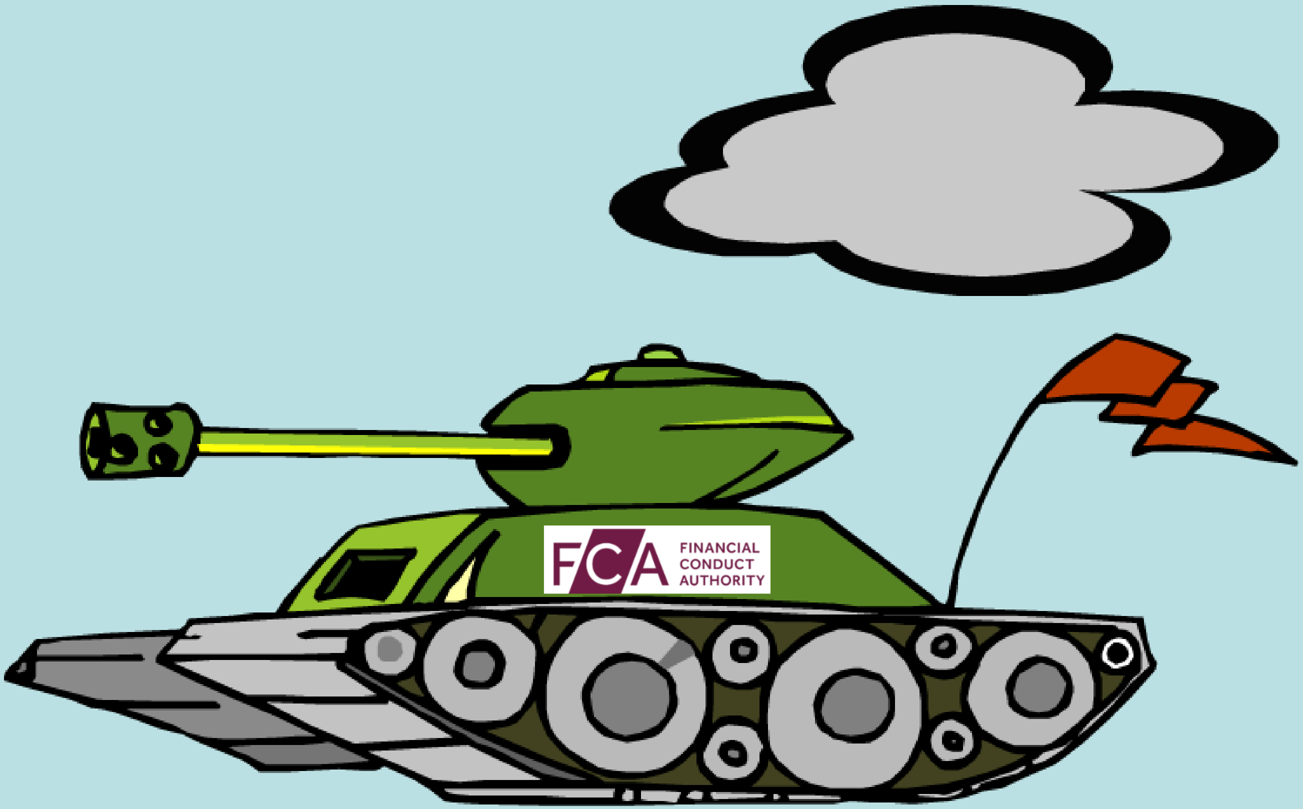
Each time the regulator thinks firms have got the message . . .

Each time it is disappointed

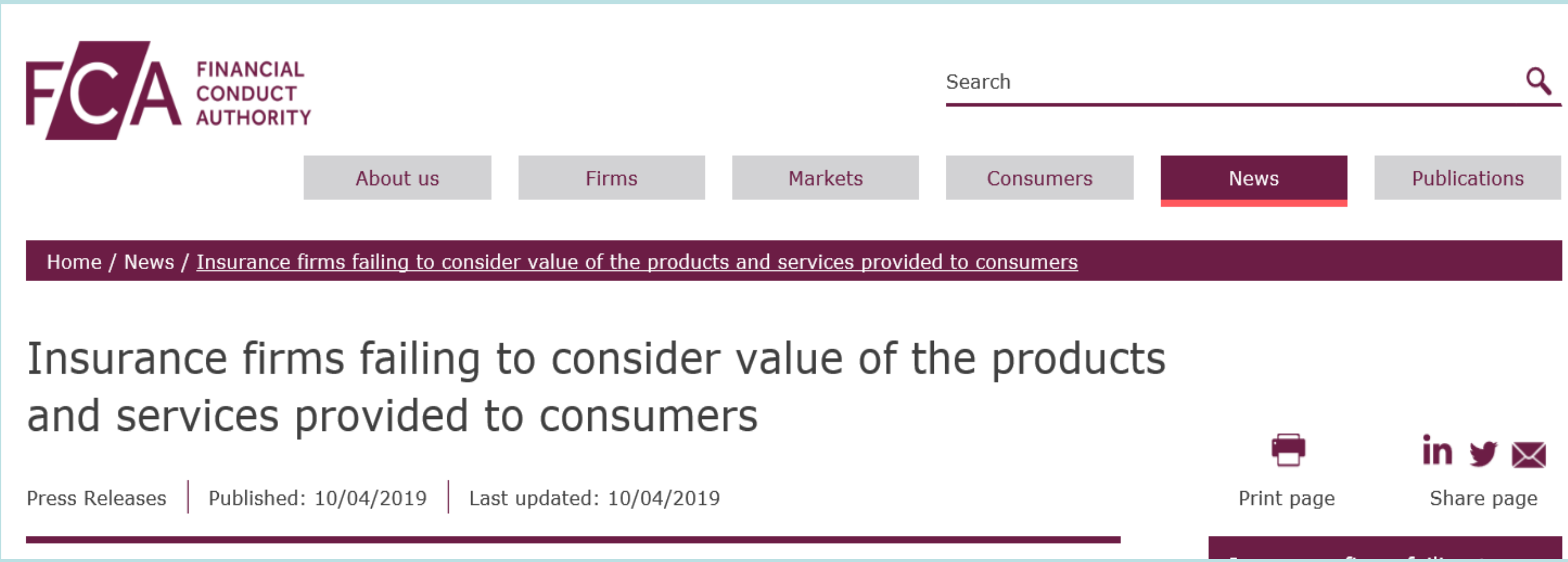
Why?

- Maybe regulatory overload
- Maybe too much regulatory "theory"
- Maybe not enough precision as to what it <u>really</u> expects
- Maybe a belief that regulatory "expectations" will change culture
- Probably that firms hear the words but they do not have the clarity to drive change from embedded cultures

So - a new line of attack by the FCA



Value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Insurance firms failing to consider value of the products and services provided to consumers

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Value – the new buzz word

- In January the FCA proposed the extension of its “value measures” pilot to all general insurance products

- This involves firms reporting product performance under specified “value measures” for publication on the FCA website

- See my March presentation to Protect on this at:-

  https://www.paginator.co.uk/project/protect-march-2019/

- Very important to understand the regulatory background and “theory” behind this

The theory of “value measures”

- Comes from FCA’s <u>competition</u> remit

- The Value Measures pilot project was a <u>remedy</u> to correct poor competition in the add-on insurance market

- If firms have to publish defined measures of the value of their product against products in the same add-on sector this will drive up value (drive down prices)

- This was supplemented by a key mechanic . . . .

A new PROD 4.5

- The IDD introduced Chapter 4 of the Product Intervention and Product Governance Sourcebook (Business Standards)
- FCA propose a new PROD 4.5 headed - "Additional expectations for manufacturers and distributors in relation to value measures data"
- Firms must review the value measures information, within a reasonable period of its publication and . . .
- do <u>whatever is necessary</u> to correct any aspects of their product which do not offer ***sufficiently good value***" (my emphasis)

The regulatory mechanism

- Using value as a comparator

- Is your product better or worse than other firms' products when applying specified value measures?

- The good news is that the value measures are defined (and therefore clear an understandable)

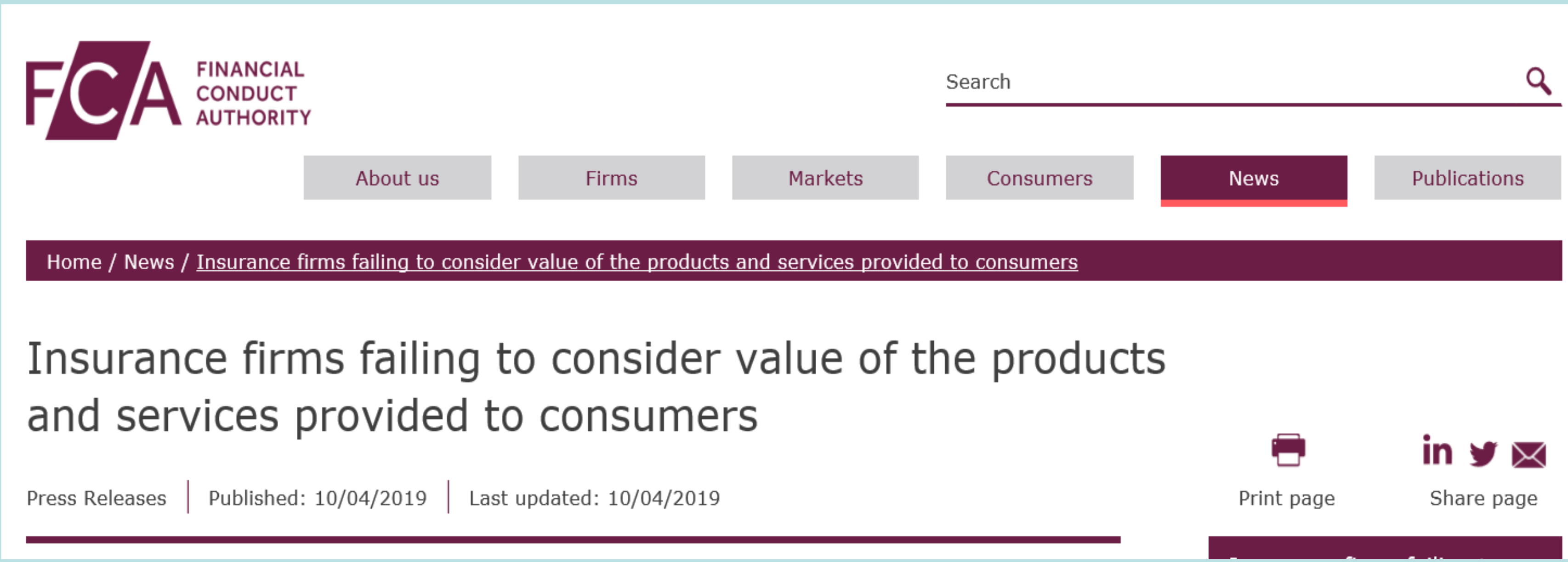
- The bad news (for firms) is that PROD 4.5 will lead to a dive to the bottom on price to deliver "value"

- Is low price a true or proper indicator of "value"?

Indeed – what <u>is</u> “value”

- Outside of the Values Measures project, so far it has just been another buzz word
- The FCA’s broader expectations on “value” have been no more capable of being pinned down than its expectations for “good consumer outcomes” or for “fairness”
- So – when the FCA say . . . .

The FCA's concern

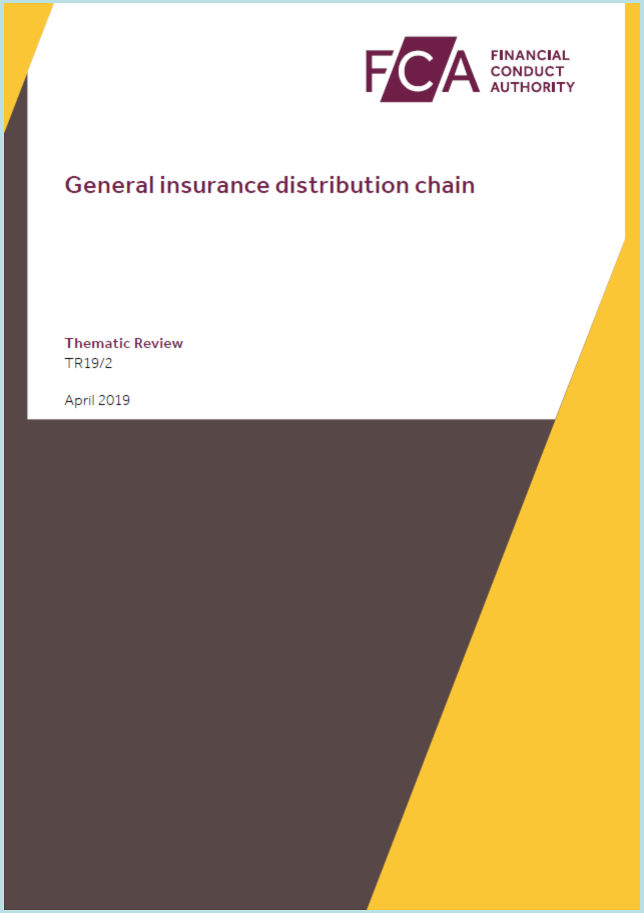


<u>What</u> “value” is it talking about?

We now have some new windows on “value”

- An FCA Thematic Review Report on General Insurance Distribution Chains
- A Consultation on proposed Guidance for insurance product manufacturers and distributors
- A Dear CEO Letter regarding FCA expectations of general insurance firms

The Thematic Review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General insurance distribution chain

Thematic Review
TR19/2

April 2019

The Key Concern

- The FCA says that the **length and complexity** of some distribution chains and the potential influence of **parties that are not regulated by the FCA** has given rise to two key risks. These are:-

  - The number (or nature) of parties in some distribution chains increases the price of GI products and adversely affects the value of the products (and associated services)

  - The complexity of chains and number of parties involved negatively affects the delivery of services and customer experiences or outcomes. This may be either during the sales process (e.g. via mis-selling) or while fulfilling obligations to customers (such as claims and complaints handling)

FCA say these risks cause harm

- Customers purchasing products which deliver little benefit
- Customers may purchase products that are less appropriate for them, where firms sell a product not offering value.
- Customers may pay substantially more for a product which delivers no additional benefits compared to alternative, less expensive products available in the market.
- Remuneration structures may lead to customers paying increased prices as a result of remuneration that is paid to firms in the distribution chain who incur little cost or deliver little benefit to customers
- Firms may fail to identify products not providing value to customers or to take appropriate remedial action, due to shortcomings in oversight, management information ('MI') or monitoring

What do we learn about value from this?

- The FCA has identified two core types of potential harm from distribution chains:-
  - lack of benefit for customers
  - overpayment by customers
- But the FCA uses “value” (or lack of) as a catch all phrase when discussing both these outcomes

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Poor Value = Lack of “benefit”

- The FCA sees a “lack of value” in customers purchasing products which deliver “little benefit”

- But that begs the question as to <u>who</u> determines what is, or is not, a product which “delivers benefit”?

- The FCA doesn’t help you with this – but they do say lack of benefit will arise:-

  - from failings in **product design and approval processes**

  - when a firm distributes the product to customers **outside the target market**

  - where conflicts of interest (usually **remuneration structures**) incentivise firms to sell a particular product.

These are all serious failings – but . . .

- It is not the quantifiable "benefit" or "value" of a particular product which is likely to attract FCA enforcement

- "Benefit" will always be a subjective assessment

- The FCA says that lack of "benefit" will exist when the **purpose and values** of a firm or a firm's **business model and strategy** are not focused on consumer outcomes

- So – FCA's focus on "lack of benefit" is not an issue of "measuring" benefit – it is focused on whether your firm complying with:-

  - the threshold for authorisation = operating a **strategy for doing business** which has **integrity**; and/or

  - the Principles for Business . . .

The Principles

1 Integrity	A *firm* must conduct its business with integrity.
2 Skill, care and diligence	A *firm* must conduct its business with due skill, care and diligence.
3 Management and control	A *firm* must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4 Financial prudence	A *firm* must maintain adequate financial resources.
5 Market conduct	A *firm* must observe proper standards of market conduct.
6 Customers' interests	A *firm* must pay due regard to the interests of its *customers* and treat them fairly.
7 Communications with clients	A *firm* must pay due regard to the information needs of its *clients*, and communicate information to them in a way which is clear, fair and not misleading.
8 Conflicts of interest	A *firm* must manage conflicts of interest fairly, both between itself and its *customers* and between a *customer* and another *client*.
9 Customers: relationships of trust	A *firm* must take reasonable care to ensure the suitability of its advice and discretionary decisions for any *customer* who is entitled to rely upon its judgment.
10 Clients' assets	A *firm* must arrange adequate protection for *clients'* assets when it is responsible for them.
11 Relations with regulators	A *firm* must deal with its regulators in an open and cooperative way, and must disclose to the *appropriate regulator* appropriately anything relating to the *firm* of which that regulator would reasonably expect notice.[1]

So what the FCA <u>really</u> means is that . . .

- Poor value (in the sense of lack of benefit) will arise where the demands and needs of customers are not placed at the centre of the product design and distribution process

- This will be where distribution is “top down” (commercially focused) and not “bottom up” (consumer focused)

- FCA will leap on any firm which does not demonstrate its <u>own</u> clear processes to meet PROD requirements for manufacturer and distributor oversight over the **purpose and values** of the firms involved in distribution or over their **business models and strategies**

- In order to avoid FCA action regarding **lack of benefit**, firms are going to have to be very clear indeed as <u>how</u> they have established that the benefits they seek to deliver are matched to a <u>consumer</u> focused assessment of customer demand/need - driven by “integrity” not by commercial gain

Poor Value = “Price”

- Now we reach the crux of the issue!
- The FCA description of poor value as evidenced by “excessive prices”
- Now it gets tricky . . .
- When is a price “excessive”?
- Are FCA in the game of price controls?

The FCA on “Excessive Prices”

“Excessive prices are where prices are disproportionate to the production and delivery costs of products and services customers receive”

Example 1

Example 3 - GAP insurance
We saw numerous examples of parties involved in the distribution chains for GAP insurance receiving high (and potentially excessive) levels of commission. The split of the average net premium (after Insurance Premium Tax) between each of the parties in 1 distribution chain we reviewed is detailed below:

Average proportion of net premium to the insurer: 27%
Average proportion of net premium to the wholesale distributor (a GI intermediary): 2%
Average proportion of net premium to the distributor (a car dealership): 71%

Example: For a customer buying a GAP policy for £360 via this particular distribution route this amount would break down as follows:

Commission to the distributor (car dealership): £213
Commission to the wholesale distributor: £6
Net premium to the insurer: £81
Insurance Premium Tax: £60

Example 2

Example 4 – 'Scratch and dent' insurance

One of the monthly 'Scratch and dent' bordereaux we reviewed listed almost 40,000 policies with total net premium after Insurance Premium Tax of £13.5m. This bordereau aggregated the sales from many different dealerships, selling both new and used cars.

The various parties involved in the distribution chain on average received the following proportions of the net premium:

Average proportion of net premium to the insurer: 33%
Average proportion of net premium to the product manufacturer (a GI intermediary): 13%
Average proportion of net premium to the distributors (a range of car dealerships): 54%

This means that of the £13.5 net premium paid by customers, £7.3m was retained by the distributors, with £4.5m going to the insurer and £1.7m to the GI intermediary who manufactured and administered the product.

Example: For a customer buying a 'Scratch and dent' policy for £300 via this particular distribution route would (on average) pay the following amounts to each party in the chain:

Commission to the distributor (car dealership): £135
Commission to the product manufacturer: £32.50
Net premium to the insurer: £82.50
Insurance Premium Tax: £50

71% of all of the 'Scratch and dent' policies listed on this particular bordereau involved commission levels above 50%. This was broadly representative and consistent with the levels of commission we saw across many similar arrangements where this product was sold.

These are "just examples"

"The examples relate to motor ancillary products, but we also saw similar issues in some travel insurance products, as well as for furniture and white goods warranty products and add-on insurances like legal expenses"

If not price control – remuneration control?

- Note the hint as to a 50% commission threshold
- Is this the unwritten benchmark (“Plevin”)?

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Where the FCA sees the problems

- The FCA says that there two features of distribution chains, which are contributing factors to the level of commissions earned within these chains:-
  - The involvement of parties who are retailers or brands and whose business is predominantly non-regulated. "**This appears to give a significant degree of influence over the regulated product and its sale (including its price) to these non-regulated parties**"
  - The point of sale advantage enjoyed by the distributors because these are secondary sales accompanying the sale of another (non-insurance) product. "**This gives the distributors ownership of the customer relationship**"
- These are issues which many Protect Members will recognise – but what does the FCA expect you to be doing about it ?

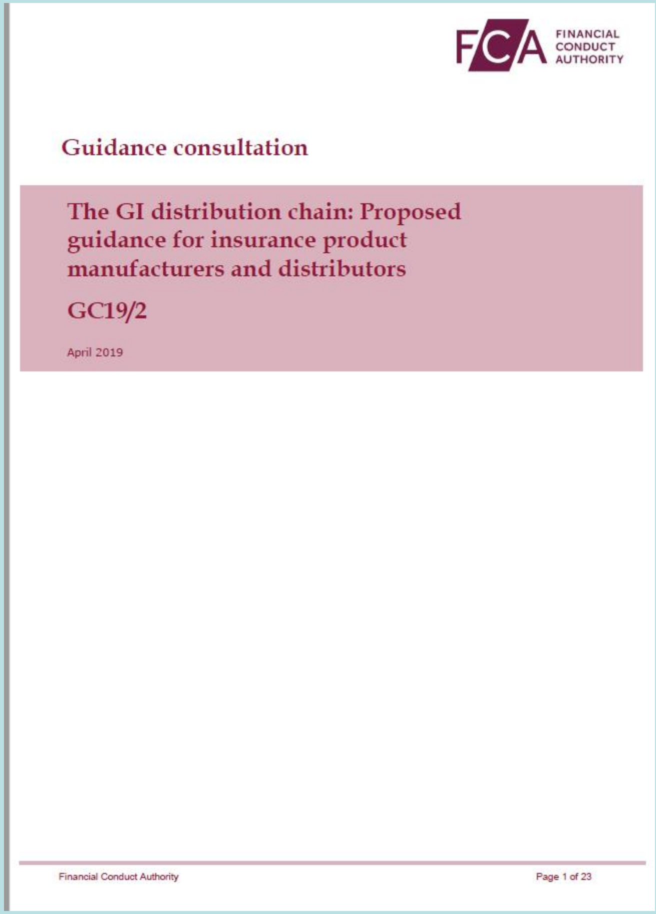
The <u>basic</u> expectation

"Firms should assess their GI activities to consider how they are meeting their obligations under our rules taking into account our proposed Guidance for Product Manufacturers and Distributors. If firms have not taken adequate steps to meet these obligations, including assessing that their GI products or services offer utility and value for customers, they must promptly take appropriate measures to mitigate the risk of harm to customers"

So FCA is saying

- That its expectations are not new
- The Principles for Business, the Threshold Conditions, the Customers' Best Interests Rule and PROD requirements are <u>already</u> in place
- A failure to deliver "value" will be because of breach of one or more of <u>these</u> obligations
- The Guidance Consultation merely proposes fleshing obligations out . . .

The Guidance Consultation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Guidance consultation

The GI distribution chain: Proposed guidance for insurance product manufacturers and distributors

GC19/2

April 2019

Financial Conduct Authority Page 1 of 23

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Guidance on the responsibilities of insurance product manufacturers

- Firms must put in place a product approval process, covering product design and review (this is an existing PROD requirement)

- As part of this process, the FCA expects manufacturers to consider the value that the product presents for its target market **and how the distribution chain affects overall value.**

- This should include consideration of:-

  - the benefits the product is intended to provide to the target market
  - the value considerations which are relevant to the target market
  - the overall cost to the end customer, including product costs and charges, and remuneration received by other parties in the distribution chain

- The FCA expects firms to be able to “appropriately evidence” these considerations and the conclusions reached

Guidance on the responsibilities of insurance product distributors

- Firms must consider the impact that their distribution strategy has on “the overall value of the product to the customer”

- Firms must ensure that the remuneration they receive for their insurance distribution activity does not <u>conflict</u> with their duty to comply with the customer’s best interests rule

- The FCA expects distributors to identify initial signs of problems with product value via:-

  - their direct interactions with customers
  - their assessments of customers’ demands and needs
  - referencing the value measures data
  - through analysis of claims or complaints

A particular emphasis on <u>remuneration</u>

- The Guidance will state that, while a product may provide benefits to the customer, the level of distributors' remuneration may mean the product fails to provide the **intended value identified in the product approval process**

- FCA say that this would mean that distributing the product would conflict with the customer's best interests rule

- Just what does this imply?

- Is the FCA suggesting that the manufacturer should be setting a "recommended retail price"?

- Not explicitly – but the FCA <u>do</u> say that distributors should "ensure that they understand the <u>product manufacturer's</u> assessment of the value the product should provide . . "

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The Dear CEO Letter

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10 April 2019

Dear CEO

FCA expectations of general insurance ('GI') firms

Today we published our thematic report on the GI distribution chain. It sets out the findings of 2 pieces of work, a thematic review of Value in the GI Distribution Chain and a multi-firm review of delegated authority arrangements (following our 2015 Thematic Review). We are also consulting on proposed non-Handbook guidance to clarify our expectations of firms as manufacturers and distributors of GI products.

Areas of potential harm

The report highlights areas where we identified significant potential for harm and poor outcomes for customers arising from the product development and distribution approaches in some sectors of the GI market. These harms include, for example, customers purchasing products that are not appropriate for them or customers paying increased prices due to remuneration paid to firms in the distribution chain who incur little cost or deliver little benefit. These potential harms are caused by firms not adequately considering the value of the products or services provided to customers, as well as failures in product design, weak oversight of the distribution chain, poorly designed distribution strategies and conflicts of interest caused by firms' remuneration structures.

Some progress has been made following our previous work in this area (i.e. TR15/7 and TR16/6). However, many GI firms have not responded appropriately and are not sufficiently focused on customer outcomes, including the value of the products and services their customers receive. We have already taken regulatory action in these areas. This includes in the case of Liberty Mutual Insurance Europe SE (who were fined £5m for failings in their oversight of claims handling and customer outcomes), Express Gifts Limited (where a £12m redress scheme was introduced following the sale of products of limited or no value) and The Carphone Warehouse (who were fined £29m for mis-selling mobile phone insurance and failing to properly investigate and fairly consider complaints arising from the mis-selling). We will not hesitate to take further action if we encounter issues and potential failings at firms which cause harm or have potential to cause harm to customers.

Impact of the IDD and the SM&CR

The new rules introduced from 1 October 2018 following our implementation of the Insurance Distribution Directive (IDD) are directly relevant to the manufacture and distribution of GI products, the concerns we have identified and the harm they may cause. These rules include the obligation on all firms involved in the GI distribution chain to act honestly, fairly and professionally in accordance with the best interests of their customers.

Our proposed non-Handbook guidance further clarifies our expectations of firms in the GI sector following the implementation of the IDD. In addition, the Senior Managers and Certification Regime (SM&CR) enhances the obligations and individual accountability of senior managers in

This sets out the "must do actions"

- Firms must act fairly, honestly and professionally in accordance with the best interests of customers and firms should consider the value customers ultimately receive from their products and services

- Firms should maintain appropriate systems and controls over the remuneration they receive and manufacturers should have sufficient knowledge of the roles and remuneration of all entities in the distribution chains they use to be able to assess the impact they have on the value customers receive

- Firms must maintain appropriate systems and controls over their GI products and services

- Distributors should consider the impact of their distribution strategy (including the distribution method and the level of remuneration they receive) on the overall value of the product for their customers.

If your firm does not do, and, evidence the "must do actions"

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A picture can paint a thousand words . .

“Value”

By ‘value’ we mean the value being provided to the end customer from the product and the distribution arrangements, including as a result of remuneration structures throughout the distribution chain. Product value includes consideration of whether the product is compatible with the objectives, interests and characteristics of the target market, as well as the costs and charges of the product itself. We consider that any target market will have interests in seeing that their overall costs do not bear an unreasonable relationship to the benefits of the product and service being provided. Overall this will enable firms to identify whether what is being provided gives rise to risk of harm or adverse effect (whether actual or potential) for customers.

(see GC19/2 Page 8)

TR19/2 – Value in the Distribution Chain

Value Measures

GC19/2

Dear CEO Letter

PROD 4.2
Oversight over product design and targeting

PROD 4.3
Oversight over distribution

PROD 4.5
Apply Value Measures information to design and distribution

Key:
Handbook requirements
Upcoming requirements
Related considerations
Key dynamics

Consider impact of the mode of distribution, pricing and (proportionate) remuneration on “Value”

Does the mode of distribution operate within a market sector displaying effective competition?

Consumers

Proposed Duty of Care?

Senior Management

Deliver Strategic integrity (COND 2.7)
Take Individual responsibility (SM&CR)
Develop resilience to FCA Supervisory Principles

Drive:-
Consumer focus
Corporate culture
Effective systems
Effective oversight
Frequent reviews

ICOBS 2.5-1R
Customer’s Best Interests Rule

TCF + other Principles for Business + proposed new or revised Principles
Other Handbook Rules

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