Developments in Conduct Standards for financial services firms

An overview of the Central Bank of Ireland's planned reforms and expectations

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The Central Bank of Ireland makes new proposals to establish an Individual Accountability Framework for staff of Irish financial services firms which would set conduct standards and clearer lines of accountability within firms.

Introduction

On 24 July 2018 the Central Bank of Ireland (**CBI**) set out a series of proposed reforms[1] that all regulated financial services providers, including insurers, can expect in terms of the CBI's supervisory and regulatory framework relating to conduct of business.

The proposed reforms cover the following items:

1. A new Individual Accountability Framework, which would go significantly beyond the current requirements for staff to be fit and proper, set Conduct Standards for staff, and ensure clearer lines of accountability within firms.
2. Enhancements to the existing Fitness & Probity Regime (**F&P Regime**) to strengthen the onus on firms to proactively assess individuals in all controlled functions (**CFs**) on an ongoing basis rather than just pre-approval controlled functions (**PCFs**).
3. More frequent, targeted supervision by the CBI of those firms that pose the greatest potential harm to consumers, including robust challenge of boards and executive management. This will include use of the CBI's Consumer Protection Risk Assessment (**CPRA**) Model, intensifying firm-specific focus.
4. Removal of the hurdle of 'participation'. This reform will allow the CBI to pursue individuals directly for their misconduct rather than only where they have participated in a firm's wrongdoing.

These reforms stem from the CBI's increased focus on conduct, behaviour and cultural issues across the financial services sector in recent years. The reforms are intended to support effective cultural change by providing firms with clarity as to the basic values on which effective culture is built.

In this briefing note we set out a summary of the CBI's proposals, which are relevant to both domestic and cross-border insurers. The proposals draw on specific lessons the CBI has taken from its analysis of the Irish retail banks, which we also highlight.

Individual Accountability Framework

The CBI is recommending an Individual Accountability Framework comprising:

- Standards of behaviour for regulated financial services providers and the individuals working within them (**Conduct Standards**)
- A **Senior Executive Accountability Regime** which ensures clearer accountability
- Enhancements to the current **Fitness & Probity Regime**

CONDUCT STANDARDS

These would apply across the regulated financial services sector. The CBI proposes three sets of standards:

- Common Conduct Standards for all staff in regulated financial services providers
- Additional Conduct Standards for senior management
- Standards for Businesses

The CBI cites that the Consumer Protection Code and F&P Regime already provide for certain conduct standards but expresses the need for their enhancement.

- In the case of individuals working in regulated financial services providers, the CBI proposes that they would be required to:
- Act honestly, ethically and with integrity;
- Act with due skill, care and diligence;

[1] The CBI's proposals are contained within its report Behaviour and Culture of the Irish Retail Banks

- Be open and cooperative with the Central Bank and other regulators and deal with them in good faith;
- Act in the best interests of customers and treat them fairly and professionally; and
- Observe proper standards of market conduct.

Recognising the specific responsibilities imposed on those in more senior roles, the CBI proposes that the following additional Conduct Standards be imposed on those in PCF roles or captured by the proposed Senior Executive Accountability Regime (see below):

- Individuals must take all reasonable steps to ensure that the business of the firm for which they are responsible is controlled effectively
- Individuals must take all reasonable steps to ensure that the business of the firm for which they are responsible complies with relevant regulatory requirements
- Individuals must take all reasonable steps to ensure that any delegation of tasks for which they are responsible is to an appropriate person and that they oversee the discharge of the delegated task effectively
- Individuals must disclose promptly, proactively and appropriately any information of which the CBI would reasonably expect notice

The CBI believes the Standards for Businesses will act as a counterbalance to the individual Common Conduct Standards, making clear that the CBI continues to expect high standards of behaviour for firms and will hold them to account based on these Standards.

The CBI's proposed Standards for Businesses are as follows:

- **Professionalism, honesty, ethics and integrity:** A firm must conduct its business professionally, honestly, ethically and with integrity.
- **Skill, care and diligence:** A firm must conduct its business with due skill, care and diligence.
- **Market conduct:** A firm must observe proper standards of market conduct, comply with relevant market codes and exchange rules, and not engage in or permit market manipulation.
- **Communications with customers:** A firm must pay due regard to the information needs of its customers; make full disclosure to its customers of all relevant material information in a way which is clear, fair and not misleading; and seek from its customers information relevant to the product or service requested.
- **Customers' interests:** A firm must act in the best interests of its customers and treat them fairly and professionally;
- **Customers and 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;
- **Management and control:** A firm must take reasonable care to organise and control its affairs, systems (including risk management systems) and resources responsibly, effectively and in a manner appropriate to the business of the firm;
- **Financial prudence:** A firm must maintain adequate financial resources and manage its affairs in a sound and prudent manner;
- **Clients' assets:** A firm must arrange adequate protection for clients' assets when it is responsible for them;
- **Conflicts of interest:** A firm must seek to avoid conflicts of interest and must manage conflicts of interest fairly; and
- **Relations with regulators:** A firm must deal with its regulators in good faith and in an open and cooperative way, and must disclose to the CBI promptly, proactively and appropriately anything relating to the firm of which the Central Bank would reasonably expect notice.

SENIOR EXECUTIVE ACCOUNTABILITY REGIME

It is proposed that a Senior Executive Accountability Regime be introduced for banks, insurance undertakings and investment firms. This would aim to ensure clearer accountability by placing obligations on firms and senior individuals within them to set out clearly where responsibility and decision-making lies for their business.

A new designation of Senior Executive Functions (**SEFs**) would include board members, executives reporting directly to the board and heads of critical business areas. The SEFs designation would at least encompass existing PCFs under the F&P Regime. The CBI says that it recognises a one-size fits all approach is not appropriate and therefore while certain SEFs may be mandatory, firms would otherwise have the flexibility to structure their senior management team as they consider appropriate provided that all prescribed responsibilities, as set out by the CBI, are assigned to SEFs.

Prescribed Responsibilities

Each SEF will have responsibilities which are inherent to that role. Additionally, it is proposed that the CBI would prescribe mandatory responsibilities for firms, which must be allocated to individuals carrying out SEFs. This will ensure that there is a SEF accountable for all key conduct and prudential risks. The CBI recognises that not all prescribed responsibilities will be relevant to every firm. Accordingly, it is proposed that there be a general list of prescribed responsibilities applicable to all firms, with tailored lists for industry sectors and based on firms' scale and complexity.

Statements of Responsibilities

It is proposed that each SEF would be required to have a documented Statement of Responsibilities which clearly sets out their role and areas of responsibility. These statements are intended to promote clarity and transparency of individual responsibilities and to provide for a more targeted assessment of the fitness and probity of SEFs by allowing their competence, knowledge, experience and qualifications to be measured against the responsibilities they have been allocated. Statements of Responsibilities would be required to be kept up to date and submitted to the CBI.

Responsibility Maps

It is proposed that firms would be required to produce Responsibility Maps documenting key management and governance arrangements in a comprehensive, accessible and clear single source of reference. It is proposed that such maps would include matters reserved to the board, terms of reference for key board committees, and reporting lines of SEFs to individuals, committees and, if applicable, within the wider group. Responsibility Maps would be required to be kept up to date and submitted to the CBI.

FITNESS AND PROBITY REGIME

The CBI proposes improving the F&P Regime in relation to firms' obligations vis-à-vis their CF roles by introducing a certification regime, which would oblige firms to certify on an annual basis that the individuals in question are fit and proper persons to perform their functions. Currently, the CBI's F&P Guidance states that firms should, on an annual basis, ask persons performing a CF role to confirm their awareness of, and compliance with, the CBI's F&P Standards. The CBI says a positive duty on firms to certify each CF strengthens the regime and increases the focus on the responsibility of firms for the conduct of their staff and their corporate culture.

CBI Supervision and Enforcement

In its report the CBI states it is committed to increasing its supervisory intensity in the area of conduct risk to ensure that boards truly understand the importance of embedding a consumer-focused culture throughout their firms and that they can demonstrate how this translates to fair outcomes for consumers in practice.

The CBI says firms can expect that, in addition to its continuing supervision of their compliance with regulation, there will be more pro-active and intense focus on their frameworks to manage conduct risk. Specifically, they can expect:

- More intrusive firm-specific supervision. The CBI will intensify its focus on the highest impact firms from a consumer perspective, including more frequent, targeted use of its CPRA Model[2].
- A newly developed consumer impact model will guide this intensified supervision of the highest impact firms. The CBI says that it will scale up its conduct supervision resources, with dedicated teams established for the highest impact firms.
- Increased challenge of boards and executive management.

The CBI also states it will develop a unified enforcement process which would apply to all contraventions of financial services legislation by firms or individuals. To ensure the credibility of the Individual Accountability Framework, it recommends the hurdle of 'participation' should be removed from the enforcement process to ensure that the CBI can pursue individuals directly for their misconduct rather than only where they have participated in a firm's wrongdoing. Currently the CBI may only pursue a 'person concerned in the management' of a firm where (1) a case has first been proven against the firm, and (2) the CBI can then prove that the individual participated in a breach by the firm.

Next Steps

In order for the CBI to impose the Conduct Standards and the Senior Executive Accountability Regime as proposed, it requires the legislative power to do so. Likewise, the changes proposed in respect of the F&P Regime and the current enforcement processes require legislative change. These include, among others, amendments to the Central Bank Act 1942, the Central Bank Reform Act 2010 and the Central Bank (Supervision and Enforcement) Act 2013. Any such legislative change will ultimately be for the Oireachtas.

The CBI therefore recommends that the Minister for Finance considers its proposals and, if considered appropriate, that engagement would commence between the Department of Finance and the CBI on the detail of the legislative changes required. The CBI acknowledges in its report that the design and implementation of the framework will be a multi-year project.

[2] Milliman Briefing Note on the CBI's CPRA Model
http://ie.milliman.com/uploadedFiles/insight/2017/CBI-CPRA-Overview.pdf

Lessons from Bank Reviews

The CBI's behaviour and culture reviews focused primarily on the executive leadership team (referred to in the report as the executive committee), due to the importance of its members in driving effective cultures in which customer interests are adequately identified, discussed and taken into account.

The reviews analysed:

- the leadership behaviour of the executive committee, including the drivers of this behaviour in terms of group dynamics and mindset; and
- the interplay between the executive committee and relevant internal stakeholders in the context of strategic decision-making.

The CBI noted a number of positive improvements in consideration of the consumer interest in strategy, decision-making and procedures. However, it also highlighted the following patterns in leadership, strategic decision-making as well as mindset that may jeopardise the successful transformation towards a consumer-focused culture:

- A lack of a collective understanding of what consumer focus actually means and what it requires in terms of behaviours.
- Executives continuing to operate in a 'firefighting' mode remnant of a crisis-era mindset.
- Occasional reversal to directive – or 'command and control' – leadership styles rather than inclusive and collaborative leadership.
- Concerns around over-optimism.
- Lack of empowerment and decision-making below executive committee level.

How Milliman Can Help

Milliman is a global thought leader on issues associated with financial, insurance and operational risk and has valuable insights into both domestic and international best practice. We recently published an in-depth report[3] looking at recent and ongoing developments in the area of conduct risk from around the globe and discussed actions firms need to take in order to address the changing business and legislative environment with regards to consumer protection.

Our consultants have a wealth of expertise in consumer protection and conduct risk. We have assisted undertakings across many areas including the following tasks:

- Development and review of firms' consumer protection risk management frameworks
- Assisting firms in preparing for onsite CPRA inspections
- Drawing up a suitable consumer risk governance structure with assigned roles and responsibilities across the three 'lines of defence' as well as preparation of consumer protection policies and operational procedures
- Advising on the extraction and analysis of suitable management information related to consumer protection issues
- Assessment of the performance of risk management systems and procedures

For more information contact your usual Milliman contact or one of the contacts listed below.

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