

Insurance - United Kingdom

General insurance intermediaries – conflicts of interest and remuneration

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Introduction

This update provides an overview of the legal and regulatory framework for conflicts of interest and remuneration in respect of general insurance intermediaries in the United Kingdom, with a particular focus on the findings of the latest review conducted by the Financial Conduct Authority (FCA)⁽¹⁾ and the impact of anticipated changes to the EU Insurance Mediation Directive.⁽²⁾

The FCA's message is clear. All general insurance intermediaries should ensure that they manage the conflicts of interest arising within their business model appropriately and check that their remuneration structures comply with existing rules and principles and result in good outcomes for customers. On a practical level, this means being able to point to:

- a board engaged with conduct issues, which properly communicates the intermediary's risk appetite within its organisation; and
- effective use of systems and controls to identify, mitigate and modify or correct any practices that may connote a lack of integrity.

The FCA is also working to increase awareness among commercial customers of their right to receive remuneration information on request.

Background

Under English law, the common law duties of a broker to act in good faith, to put the client's interests before its own and not to make a secret profit are well established.

Overlaying these longstanding principles, regulatory rules – principally, the FCA Principles for Businesses, the Insurance Conduct of Business Sourcebook (ICOBS) and the Systems and Controls Sourcebook (SYSC) – require that any potential conflicts of interest be managed fairly (especially in the context of the soliciting or accepting of inducements), and that customers be informed of the basis on which the broker's service is provided (ie, on a fair market analysis basis or on an exclusive basis for one or more insurers). In 2009 the British Insurance Brokers' Association also issued guidance on conflicts of interest in the commercial insurance market, which was reconfirmed in 2012 by the former UK financial services regulator, the Financial Services Authority, for a further three years. The regulatory framework makes clear that the fair management of potential conflicts of interest for the protection of customers falls on brokers and insurers alike.

FCA review

Broker business models (including remuneration structures) have evolved considerably as brokers have shifted away from simply acting as intermediaries to performing tasks that have traditionally been undertaken by insurers (eg, product design, underwriting and claims handling). Against this backdrop, in July 2013 the FCA launched a review as to whether corresponding modernised systems and controls relating to conflicts of interest had emerged and whether the broker's duty to get the best outcome for customers had been compromised.

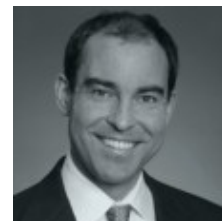
The FCA review focused on the small and medium-sized enterprise market. However, the following of the FCA's findings (published in May 2014) are of wider relevance to general insurance intermediaries.

Evolved business models

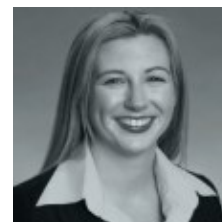
Conflicts of interest largely relate to the structure of intermediaries' businesses and their sources of revenue. Firms and groups operating more traditional broker models (where revenue is earned as

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agent of the customer) and managing general agents (which operate solely as agent of the insurer) are less exposed to conflicts of interest. The FCA found that exposure was higher for firms and groups operating integrated models whereby they take on a dual agency role. Promotional communications from managing general agents to customer-facing broking teams sometimes focused predominantly on the enhanced remuneration attaching to products, rather than on customer benefits. Failure to segregate remuneration information between the broking arm and the managing general agent in integrated models can result in brokers being aware of enhanced commission for placing certain products. Some intermediaries display a lack of understanding of how their evolved business models and remuneration structures have resulted in a range of conflicts of interest that could influence the placement process.

Weak management and control frameworks

The FCA found that control frameworks and management information in some firms had developed at a slower pace than their business models, with particular regard to the following:

- Agency role – a number of firms could not confirm the number of cases in which they acted as agent of the customer, agent of the insurer or in a dual or mixed agency capacity.
- Firm policies – firms' policies and principles on conflicts of interest, while sensible, had no measurable outputs to ensure their implementation. Firms should monitor the impact of different remuneration arrangements on their placement activities.
- Tender and review processes – remuneration available to intermediaries, rather than customer needs, was often the focus of negotiations over underwriting capacity for products with insurers. Product features and value for the customer should dominate the selection process and an audit trail of an insurer's selection should be kept, including regular reviews of, and sufficient flow of management information on, ongoing product suitability with benchmarking of the insurer's performance against specified metrics.

Over-reliance on compliance with ICOBS disclosure rules

Under ICOBS 4.4, insurance intermediaries must disclose commercial information at the request of a commercial customer. It should be clear from each disclosure what work has been done for the customer requesting the information, the capacity in which the firm has acted and how the intermediary has been remunerated.

The FCA found that some firms relied on compliance with the ICOBS 4.4 commission disclosure rule to address risks arising from conflicts generated by their business and remuneration models that were not mitigated by their control frameworks. However, firms must still meet their SYSC obligations (SYSC 10.1.7R and 10.1.9G) to:

"maintain and operate... arrangements with a view to taking all reasonable steps to prevent conflicts of interest... from constituting or giving rise to a material risk of damage to the interests of its clients."

Revision of Insurance Mediation Directive – new remuneration disclosure provisions

Intermediaries must also be aware of new remuneration disclosure provisions under the recast Insurance Mediation Directive. Trialogue discussion is now underway, with the final text expected to be approved towards the end of 2014 and to come into force in 2016.

The European Commission's initial proposals, which were published in July 2012, envisaged greater disclosure about the amount and source of remuneration, including the introduction of a mandatory full disclosure regime. The European Parliament's approval of various amendments to the initial text in February 2014 significantly watered down these proposals so that remuneration disclosure will now be given only on request from the customer.

The provisions will not apply to the mediation of large risks or mediation by reinsurance intermediaries or reinsurance undertakings, or in relation to 'professional customers'. The list of 'professional customers' includes a catch-all provision that the customer possesses the experience, knowledge and expertise to make its own decisions and assess properly the risks that it incurs. The provisions will therefore principally affect brokers' dealings with retail customers in the context of non-investment insurance contracts, where currently no such remuneration disclosure requirements under ICOBS apply.

In the United Kingdom, the impact of the extension of the 'on request' regime to non-professional customers will depend on how often customers elect to receive this information. A key criticism of the original proposal to introduce a mandatory disclosure regime for general insurance products was that customers buying general insurance products typically focus on quality of cover and level of premium, so that showing customers how much of the premium is paid as commission is unlikely to affect the purchasing decision. The FCA review confirmed that the number of small and medium-sized enterprise customers exercising their rights under ICOBS 4.4 to receive remuneration disclosure is low. However, in addition to customer focus on overall price, the FCA considered that this lack of interest in intermediary remuneration may be driven by a widespread misconception that commission was typically around 15% lower than it actually was. The FCA's efforts to close the gap between customers' perception and the reality of commission levels may therefore encourage more customers to exercise their rights to receive this information and use it in their assessment of which product to buy.

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Endnotes

(1) "Commercial insurance intermediaries – Conflicts of interest and intermediary remuneration" (TR14/9), May 2014, available at www.fca.org.uk/static/documents/thematic-reviews/tr14-09.pdf.

(2) See www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2014-0155#BKMD-29.

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