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Advanced insurance broking

930

2022
**STUDY
TEXT**

Advanced insurance broking

930: 2022 Study text

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Print edition ISBN: 978 1 80002 317 8

Electronic edition ISBN: 978 1 80002 318 5

This edition published in 2021

The author

The CII would like to thank **Paul Maynard, FCII** for his assistance with the 930 study text for which he was the author for many years. Paul was Chief Placement Officer for Willis UK, responsible for broking, technical standards and training and competency and had over 40 years' experience in the London Market, principally as a broker and account director of major accounts.

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The CII would also like to thank the following for their assistance with previous editions of this study text:

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Acknowledgement

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Typesetting, page make-up and editorial services CII Learning Solutions.

Printed and collated in Great Britain.

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Using this study text

Welcome to the **930: Advanced insurance broking** study text which is designed to cover the 930 syllabus, a copy of which is included in the next section.

Please note that in order to create a logical and effective study path, the contents of this study text do not necessarily mirror the order of the syllabus, which forms the basis of the assessment. To assist you in your learning we have followed the syllabus with a table that indicates where each syllabus learning outcome is covered in the study text. These are also listed on the first page of each chapter.

Each chapter also has stated learning objectives to help you further assess your progress in understanding the topics covered.

Your Advanced Diploma study material has been designed to help you develop study skills that you may not be familiar with. The aim is that you should engage actively with the text, which contains a number of features designed to assist your learning and study.

You will be directed to alternative sources of theory and practice (**useful websites/ additional reading**), encouraged to learn from your own experiences (**research exercises**), to think critically (**critical reflections**) and provided with opportunities to apply your knowledge and skills through practical application (**scenarios**).

Guide to your study text



Additional reading or useful articles: provide valuable references to books, journals and articles on related subjects.



Be aware: draws attention to important points or areas that may need further clarification or consideration.



Consider this: stimulating thought around points made in the text for which there is no absolute right or wrong answer.



Critical reflections: challenge you to think beyond the confines of the text.



Examples: provide practical illustrations of points made in the text.



Key terms: introduce the key concepts and specialist terms covered in each chapter.



Management decisions: are questions management may need to address. They encourage you to understand the mindset of management.



Refer to:

Refer to: extracts from other CII study texts, which provide valuable information on or background to the topic. The sections referred to are available for you to view and download on RevisionMate.



Reinforce: encourages you to revisit a point previously learned in the course to embed understanding.



Research exercises: reinforce learning through practical activities.



Sources/quotations: cast further light on the subject from industry sources.



On the Web: introduce you to other information sources that help to supplement the text.

Study skills

As we have already stated, the Advanced Diploma study material requires you to **engage** with the text in a way that makes you capable of applying the knowledge you have gained to practical work situations. While the text will give you a foundation of facts and viewpoints, your understanding of the issues raised will be richer through adopting a range of study skills. They will also make studying more interesting!

We will focus here on the need for **active learning** in order for you to get the most out of this core text. However, the CII's online learning site, RevisionMate, covers a range of other study skills that will be helpful to you in more specific areas of your studies, such as using diagrams and tables, how to approach case study style questions, and how to identify your own learning style to help you approach studying in a way that best suits you and will get you the best results possible.

Active learning is experiential, mindful and engaging

- **Underline or highlight key words and phrases** as you read – many of the key words have been highlighted in the text for you, so you can easily spot the sections where key terms arise; boxed text indicates extra or important information that you might want to be aware of.
- **Make notes in the text**, attach notes to the pages that you want to go back to – chapter numbers are clearly marked on the margins and key passages have been pulled out for quick reference.
- **Read critically and raise questions about the text**, apply it to your experiences, make the subject 'live' – there are 'critical reflections' to encourage you to consider the facts that you have read in the context of a working environment and the scenario questions are designed to make you think about applying the knowledge in the same way.
- **Make connections to other CII units** – throughout the text you will find 'refer to' boxes that tell you the chapters in other books that provide background to, or further information on, the area dealt with in that section of the study text.
- **Take notice** of headings and subheadings.
- **Use the clues in the text** to engage in some further reading to increase your knowledge of a particular area and add to your notes – be proactive!
- **Use the research exercises and critical reflections** to understand what you learn in a real life application, not just memorise it.
- **Relate** what you're learning to your own work and organisation.
- **Be critical** – question what you're reading and your understanding of it.

Five steps to better reading

- **Scan**: look at the text quickly – notice the headings (they correlate with the syllabus learning outcomes), pictures, images and key words to get an overall impression.
- **Question**: read any questions related to the section you are reading to get a feel for the subjects tackled. More are available on RevisionMate.
- **Read**: in a relaxed way – don't worry about taking notes first time round, just get a feel for the topics and the style the book is written in.
- **Remember**: test your memory by jotting down some notes without looking at the text.
- **Review**: read the text again, this time in more depth by taking brief notes and paraphrasing.

Useful websites

www.macmillanihe.com/studentstudyskills/page/index/

www.open.ac.uk/skillsforstudy

www.cii.co.uk/learning/knowledge-services/

Note: website references correct at the time of publication.

Examination syllabus



Chartered
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Advanced insurance broking

Purpose

To provide knowledge and understanding of the management and operation of insurance broking organisations.

Assumed knowledge

It is assumed that the candidate already has the knowledge gained from a study of the relevant sections of IF1 Insurance, legal and regulatory, M05 Insurance law and M81 Insurance broking practice or equivalent examinations.

Summary of learning outcomes

- | | |
|----|---|
| 1. | Analyse the competitive environment for insurance brokers |
| 2. | Analyse the management, implementation and control of regulation, compliance and the law as they apply to insurance brokers |
| 3. | Analyse the operational and management challenges faced by insurance brokers |

Important notes

- Method of assessment: Coursework – 3 online assignments (80 marks). Each assignment must be individually passed.
- The syllabus is examined on the basis of English law and practice unless otherwise stated.
- Candidates should refer to the CII website for the latest information on changes to law and practice and when they will be examined:
 1. Visit www.cii.co.uk/qualifications
 2. Select the appropriate qualification
 3. Select your unit from the list provided
 4. Select qualification update on the right hand side of the page

1. Analyse the competitive environment for insurance brokers

- 1.1 Explain the non-life insurance market and the insurance market cycle including its impact on insurance broking.
- 1.2 Analyse the role of brokers within the insurance market and their impact on it.
- 1.3 Examine the distribution models used by insurers and brokers, including transacting business with other brokers, and the new business process.
- 1.4 Examine the different methods of trading with clients.
- 1.5 Analyse the significant disruptive factors within the competitive environment: political, economic, social, technological, legal and environmental.

2. Analyse the management, implementation and control of regulation, compliance and the law as they apply to insurance brokers

- 2.1 Explain the regulatory environment and the approach to regulation and supervision.
- 2.2 Explain the implementation and control with respect to senior management systems and controls (SYSC) and ICOBs.
- 2.3 Explain the Senior Managers and Certification Regime (SM&CR) and the Insurance Distribution Directive (IDD).
- 2.4 Explain the disciplinary procedures to which insurance brokers are subject and their implications.
- 2.5 Examine avoiding and managing conflicts of interest.
- 2.6 Explain the importance of training and competence.
- 2.7 Review the approach brokers need to adopt to ensure positive customer outcomes.
- 2.8 Explain the procedures for dealing with complaints.
- 2.9 Examine the management of third parties, appointed representatives and introducers.
- 2.10 Explain the legal environment with reference to bribery sanctions and competition legislation and regulation.

3. Analyse the operational and management challenges faced by insurance brokers

- 3.1 Describe the various types of intermediary – by size, specialism and geographical scope.
- 3.2 Analyse typical management and organisational structures.
- 3.3 Examine the challenge of international/global business.
- 3.4 Examine the importance of strategic tools and internal operational, management, quality and financial controls.
- 3.5 Examine the role of corporate risk management within insurance brokers.
- 3.6 Explain the process of insurer selection with specific reference to the analysis of the security of insurers and other intermediaries.
- 3.7 Explain the role of Terms of Business Agreements with insurers and clients.
- 3.8 Explain the management of managing general agents and delegated underwriting authorities.

- 3.9 Examine the impact of public opinion on the wider insurance industry and the role of Chartered Broker status in raising professional standards.
- 3.10 Examine the implications of outsourcing and off-shoring.
- 3.11 Examine the importance of the business driving IT and data analytics.
- 3.12 Analyse how brokers provide excellent client service, including the management of the annual renewal cycle.
- 3.13 Examine the role of specialisation and segmentation within brokers.
- 3.14 Analyse the role of claims and different approaches to claims service.
- 3.15 Analyse the ways in which brokers are remunerated.
- 3.16 Describe the provision of risk related services and solutions by brokers.

Reading list

The following list provides details of various publications which may assist you with your studies.

Note: The examination will test the syllabus alone. However, it is important to read additional sources as 10% of the exam mark is allocated for evidence of further reading and/or the use of relevant examples.

The reading list is provided for guidance only and is not in itself the subject of the examination.

The publications listed here provide a wider coverage of syllabus topics.

CII study texts

Advanced insurance broking. London: CII. 930 study text.

Insurance law. London: CII. M05 study text.

Insurance broking practice. London: CII. M81 study text.

Insurance, legal and regulatory. London: CII. IF1 study text.

Books / eBooks

A practitioner's guide to Solvency II. Geoffrey et al. (eds.). London: Thomson Reuters, 2016.

Bowstead and Reynolds on agency. Peter Watts & FMB Reynolds. 21th ed. London: Thomson Reuters, 2017.

'Claims against insurance brokers'. Chapter 16 in Insurance claims. 4th ed. Alison Padfield. Tottel, 2016.

Digital insurance: business innovation in the post-crisis era. Bernardo Nicoletti. Basingstoke: Palgrave Macmillan, 2016.*

Financial services marketing: an international guide to principles and practice. 2nd ed. Christine Ennew and Nigel Waite. Oxford: Routledge, 2013.*

Insurance brokers: an industry accounting and auditing guide. 5th ed. M Grice, S Ouarbya. London: CCH Wolters Kluwer, 2013.

The law of insurance broking. 3rd ed. Christopher Henley. London: Sweet & Maxwell, 2016.

The role of agents in insurance business. Chapter – MacGillivray on insurance law:

relating to all risks other than marine. 13th ed. Sweet & Maxwell, 2015.

Ebooks

The following ebooks are available through Discovery via www.cii.co.uk/elibrary (CII/PFS members only):

Corporate performance: a ratio-based approach to country and industry analyses. Julia Koralum-Bereznicka. Springer, 2013.*

Risk management and corporate governance in the 21st Century digital economy. Georgios Zekos. New York: Nova Scotia Pub. Inc, 2014.*

Strategic management in the 21st Century. Vijay R. Kannan. Calif: Praeger, 2013.

Treatises on Solvency II. Meinrad Dreher. Heidelberg: Springer, 2015.

Journals and magazines

Insurance age. Incisive media. Monthly. Contents searchable online at www.insuranceage.co.uk.

Insurance day. London: Informa. Daily except weekends. Articles searchable online at www.insuranceday.com.

Insurance times. London: Newsquest Specialist Media. Weekly. Contents searchable online at www.insurancetimes.co.uk.

Financial adviser. London: FT Business. Weekly. Available online at www.ftadviser.com.

Money marketing. London: Centaur Communications. Weekly. Available online at www.moneymarketing.co.uk.

Post magazine. London: Incisive Financial Publishing. Monthly. Contents searchable online at www.postonline.co.uk.

Reference materials

Concise encyclopedia of insurance terms. Laurence S. Silver, et al. New York: Routledge, 2010.*

Specimen guides

Specimen guides are available for all coursework units.

These are available on the CII website under the unit description / purchasing page. You will be able to access this page from the Qualifications section of the CII website: www.cii.co.uk/qualifications.

* Also available as an ebook through eLibrary via www.cii.co.uk/elibrary (CII/PFS members only).

Exam technique/study skills

There are many modestly priced guides available in bookshops. You should choose one which suits your requirements.

930 syllabus quick-reference guide

Syllabus learning outcome		Study text chapter and section
1.	Analyse the competitive environment for insurance brokers	
1.1	Explain the non-life insurance market and the insurance market cycle including its impact on insurance broking.	1A, 1B
1.2	Analyse the role of brokers within the insurance market and their impact on it.	1C
1.3	Examine the distribution models used by insurers and brokers, including transacting business with other brokers, and the new business process.	2A, 2B, 2C, 2D, 2E, 2F, 2G, 2H, 3A, 3B, 3C, 3D, 3E, 4A, 4B, 4C, 4D, 4E
1.4	Examine the different methods of trading with clients.	2B, 2C, 2E
1.5	Analyse the significant disruptive factors within the competitive environment: political, economic, social, technological, legal and environmental.	2A
2.	Analyse the management, implementation and control of regulation, compliance and the law as they apply to insurance brokers	
2.1	Explain the regulatory environment and the approach to regulation and supervision.	5A, 5B, 5C, 5D, 5F, 5G, 5I, 5L, 6A, 6B
2.2	Explain the implementation and control with respect to senior management systems and controls (SYSC) and ICOBs.	5E, 5H
2.3	Explain the Senior Managers and Certification Regime (SM&CR) and the Insurance Distribution Directive (IDD).	3A, 5C, 5F, 5G, 5H, 5L, 6D, 6G
2.4	Explain the disciplinary procedures to which insurance brokers are subject and their implications.	5F, 5H, 5J, 5K
2.5	Examine avoiding and managing conflicts of interest.	6C
2.6	Explain the importance of training and competence.	5H, 6D, 13C
2.7	Review the approach brokers need to adopt to ensure positive customer outcomes.	6E
2.8	Explain the procedures for dealing with complaints.	5K, 5L, 6F
2.9	Examine the management of third parties, appointed representatives and introducers.	6G
2.10	Explain the legal environment with reference to bribery sanctions and competition legislation and regulation.	5K, 6H, 6I, 6J, 6K, 6L, 6M
3.	Analyse the operational and management challenges faced by insurance brokers	
3.1	Describe the various types of intermediary – by size, specialism and geographical scope.	7A, 9C
3.2	Analyse typical management and organisational structures.	7A, 8E, 9A
3.3	Examine the challenge of international/global business.	9B
3.4	Examine the importance of strategic tools and internal operational, management, quality and financial controls.	8A, 8F, 13A, 13B
3.5	Examine the role of corporate risk management within insurance brokers.	7B
3.6	Explain the process of insurer selection with specific reference to the analysis of the security of insurers and other intermediaries.	10A, 10B, 10C, 10D, 10E
3.7	Explain the role of Terms of Business Agreements with insurers and clients.	9D, 11D
3.8	Explain the management of managing general agents and delegated underwriting authorities.	9E

Syllabus learning outcome		Study text chapter and section
3.9	Examine the impact of public opinion on the wider insurance industry and the role of Chartered Broker status in raising professional standards.	9F
3.10	Examine the implications of outsourcing and off-shoring.	8B
3.11	Examine the importance of the business driving IT and data analytics.	8C
3.12	Analyse how brokers provide excellent client service, including the management of the annual renewal cycle.	11A, 11B, 11C, 11E, 11F, 13A, 13B, 13C
3.13	Examine the role of specialisation and segmentation within brokers.	8D
3.14	Analyse the role of claims and different approaches to claims service.	11G
3.15	Analyse the ways in which brokers are remunerated.	12A, 12B, 12C
3.16	Describe the provision of risk related services and solutions by brokers.	11H

Introduction

930: Advanced insurance broking is an Advanced Diploma unit intended for students who are highly experienced in providing broking services and who are in, or aspire to, senior broking and management positions. You should already have a sound grounding in the general principles of insurance and aspects specific to broking as provided by *IF1 Insurance, legal and regulatory*, *M05: Insurance law* and *M81: Insurance broking practice*, or equivalent examinations.

The overall aim of this unit is to provide students with an introduction to the concepts and processes of broking management.

The text covers the examination syllabus, which is designed to enable the student to understand and evaluate the:

- competitive environment for insurance brokers;
- operational and management challenges faced by insurance brokers; and
- management, implementation and control of regulation, compliance and legal aspects.

Success in the 930 assessment will require you to be able to:

- evaluate key issues and concepts: this means that you must be able to demonstrate skills in comparing and contrasting, assessing value and making informed choices;
- apply knowledge and skills to practical situations using information, methods, concepts and theories and solving problems; and
- synthesise different aspects of the syllabus: this means you must be able to demonstrate skills in using old ideas to create new ones and draw conclusions.

The syllabus learning outcomes support the principle that understanding how and when to use knowledge is as important as the knowledge itself. This study material has been designed to support the achievement of these outcomes, but you should note that success in the 930 assessment will require you to undertake further reading and independent research/learning beyond this core text.

Suggestions for further reading are included in the Reading List at the end of the Examination syllabus and, occasionally, as additional reading at the end of a particular chapter. You will also find that a number of research activities and other activities are included (see the Using this study text section for further detail). Taking time to do these extra activities will not only enhance your chances of success in the assessment, but also increase your effectiveness in your chosen career.



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- **Examination guide** – a specimen paper with answers to help prepare you for the exam

*accessible via web browser and available for selected written exam and MCQ units only (not including mixed assessment)



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The insurance broking environment

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This chapter relates to **syllabus section 1**.

Learning objectives

On completion of this chapter and your own private research with independent study of additional material, you should be able to:

- explain the non-life insurance market and the market cycle, including its impact on insurance broking; and
- analyse the role of brokers within the insurance market and their impact on it.

Introduction

Insurance buying habits have evolved over the years, with buyers having a myriad of choices on where, from whom and how they buy their insurance. This has led the Insurance broking sector to evolve, with consolidating and the number of brokers operating in the UK markets reducing. There are similar changes worldwide, but this has been exacerbated in the UK due to a number of factors.

FCA statistics suggest that there are 5,083 intermediary firms (FCA Data Bulletin Issue 9 May 2017) and according to the British Insurance Brokers Association (BIBA) there are approximately 3,000 general insurance brokers in the UK. General insurance brokers contribute 1% of GDP to the UK economy; they arrange 72% of all general insurance with a premium totalling £62.7bn and around 93% of all commercial insurance business.

Brokers come under many guises and specialisms, such as UK operating brokers, international brokers, reinsurance brokers, specialist scheme and niche brokers. The evolution of the broking market has been due to external changes in trading methods, the transfer of financial markets out of the traditional financial hubs and the introduction of more stringent regulatory requirements. These factors have dramatically changed the broking landscape.

Regulation has had a significant impact on broking businesses in terms of cost, resources, systems and processes. Before the change of regulator to the Financial Services Authority (FSA) (now split into three regulators, including the Financial Conduct Authority (FCA)), brokers had voluntary regulation through the General Insurance Standards Council (GISC).



Consider this...

Examine the impact of regulation on the broking industry, compared with other sectors of the financial services industry.

There has been a surge in brokers acquiring other businesses, especially in the last 10-15 years. This can be attributed to insurance premiums remaining stable and, in some circumstances reducing, because of the competitive market in certain sectors of insurance business, in addition to the availability of capital due to low interest rates. The sector has seen an increase of refinancing and management buy-outs (MBOs) with the rise in private equity firms investing in the broking industry. Organic growth in general lines of business has been difficult to sustain and growth through acquisition has been the trend.

Insurance rates continue to be at the bottom of the insurance cycle and the long-term impact of having a competitive advantage for many brokers is the shift from commission to fees, particularly on large commercial business. Clients are also more aware about the need for transparency and will request information on what the broker is earning. Added value to the broker's proposition is therefore pivotal. Some brokers are being upfront and disclosing their income to their clients without being asked, in the interest of transparency and to build trust with their clients.

In February 2017, Elizabeth Truss (then Lord Chancellor) decided the Ogden rate would be reduced from 2.75 to -0.75%, effective from March 2017. The rate of 2.75% had been in existence since 2001. There was outcry from the insurance industry that such a reduction in rate would push claim payments for serious injuries to an unprecedented level and insurers would have to increase the rates charged for liability premiums to compensate.

A consultation paper was put into place on 30 March 2017 requesting comments to be submitted by 11 May 2017. In this period the Elizabeth Truss was replaced by David Lidington as Lord Chancellor due to a Government reshuffle. The findings of the consultation were not issued until September 2017, after which the new Lord Chancellor confirmed proposed reforms to move the injury discount rate back to between 0% and 1%, to better reflect evidence of 'the actual investment habits of claimants'.

The Government reported that it wanted to ensure the rate is reviewed at least every three years with the support of an independent expert panel. This has been regarded as a good move. However, 8 January 2018 saw another change to the position of Lord Chancellor with David Gauke taking the helm, and over 18 months later, on 15 July 2019 - the Lord Chancellor announced that the new Personal Injury Discount Rate will be set at - 0.25%, following the consultation process and as set out within the Civil Liability Act 2018.

On the Web

You can read the September 2017 Personal Injury Discount Rate report from the Ministry of Justice here:

bit.ly/2ACgdpV.

**Research exercise**

What has been the effect of fixing Personal Injury Discount Rate at -0.25%? How has the market responded to this change?



The increase in Insurance Premium Tax from 6% to 9.5%, announced in the July 2015 Budget came into effect on 1 November 2015. Two further increases have occurred since then; a rise to 10% took effect from 1 October 2016 and a further rise to 12% took effect from 1 June 2017. Given the 2020 economic turmoil caused, amongst other things, by Covid-19, do not be surprised if this is increased by the UK Government in order to generate extra tax revenue.

Research exercise

Should brokers charge fees rather than commission? Would doing so align brokers with other professions such as solicitors, accountants etc.?



In this chapter, we examine the non-life insurance market, the insurance market cycle and its impact on brokers. We also review the general role of brokers and their impact on the market.

Resources, including websites and publications, are recommended throughout this study text.

Key terms

This chapter features explanations of the following terms and concepts:

Agency	Hard market	Market cycle	Recession
Soft market			



A The insurance market in the UK and in a global context

The ABI's *State of the Market Report* 2018 shows that the UK insurance industry is the largest in Europe and the fourth largest in the world, with a total premium income of just under £225bn.

The UK insurance industry employs around 324,100 individuals, of whom more than a third are employed directly by insurers and the remainder in auxiliary services such as broking and claims handling.

In a global context, in 2016, the UK was fourth in the table of premium income:

1.	USA	£998,102m
2.	Japan	£347,830m
3.	People's Republic of China	£344,019m
4.	UK	£224,515m
5.	France	£175,389m

Source: ABI UK Insurance and Long-Term Savings: *The state of the market*, 2018 (accessed via: www.abi.org.uk/globalassets/files/publications/public/data/abi_bro4467_state_of_market_v10.pdf).

Special factors to note:

- The UK industry generates almost one-quarter of total EU premium income.
- In 2016, the UK life sector received almost twice as much premium volume (£147bn) as the non-life sector (£77bn).
- US liability premiums tend to be higher in aggregate due to the nature and cost of litigation.
- In Japan the majority of the population live in relatively small apartments, and so the total value of the housing stock is proportionately less than the UK, where the majority live in houses. As was seen in the earthquake of 2011, many individuals and indeed businesses do not buy cover for either shock damage or tsunami.
- The UK has a very high rate of compliance, i.e. nearly all businesses buy insurance. The most recent Health and Safety Executive (HSE) numbers show that there were fewer than 20 prosecutions for failure to arrange compulsory employers' liability insurance. Even allowing for the limited resources of the HSE, and even if this number was multiplied by 100, that would still be tiny when considered alongside the over 2,000,000 businesses that have to buy this cover.
- Despite the growth of China and India, the total world market is dominated by the top 20 economies, mainly comprising the more developed Western-style economies with the USA and the EU accounting for approximately two thirds of the premium income.
- Brexit could have an effect on the business placed in the UK if an agreement is not in place for access to the European single market. Since the referendum in June 2016, insurers and multinational brokers have been setting up hubs and offices in the EU and some are even looking at moving their headquarters out of the UK.



Brexit

The UK voted to leave the European Union (EU) on 23 June 2016 and left on 31 January 2020. A transition period applied until 31 December 2020, during which the UK continued to follow all the EU's rules.

At 11pm on 31 December 2020, UK insurers lost their passporting rights to write insurance business in the European Economic Area (EEA). To continue servicing their EEA clients, many UK insurers decided to operate through their subsidiaries in the EEA, while the UK agreed to EEA companies continuing their activities in the UK as branches. Some European insurance regulators have recently challenged such arrangements, particularly where the new European operation was set up by the UK insurer purely to deal with EU insurance business post Brexit and it has no, or only a limited number of, employees physically present in the relevant EU Member State.

Regarding the run-off period for existing contracts, the UK has allowed EEA insurers a 15-year period to continue servicing such contracts with UK insureds. The matter is more complex for UK insurers' contracts with EEA insureds, as every EU State has implemented different rules which apply to UK insurers in its jurisdiction.

Negotiations about an equivalence regime between UK and EU insurance regulation started in March 2021 with the aim of establishing a Memorandum of Understanding (MoU). Both sides agree to the content of the MoU, but it has not been officially approved by the EU. The UK Government remains hopeful that the MoU will be signed off but two stumbling blocks remain – matters relating to the Northern Ireland Protocol and an internal EU debate about whether the MoU constitutes a discussion framework or a more formal arrangement for regulatory cooperation. If it is the latter, then EU institutions will want to play a role in determining the nature of that cooperation.

The matter is also uncertain because the EU has not confirmed its readiness to grant an equivalence regime. The main reason is the suggested, possible divergence by the UK from EU rules in the future.

Please note: This is the position at the time of publication. Any relevant changes that may affect CII syllabuses or assessments will be announced as they arise on the qualification update page for the unit.

Research exercise

Investigate the differences between the insurance sectors, both commercial and personal, in a selection of Western and other economies.

Review the UK's exit from the EU, what it means to trade under WTO terms following the end of the transition period, what agreement has been put in place by the UK Government and the EU, and identify how this might affect insurance brokers.

**A1 The UK non-life market**

Of the estimated 324,100 people employed in the insurance industry (including life, savings and investments), the City of London has the highest regional employment with 51,000 jobs, but there are other key insurance employment hotspots, including:

- Leeds (18,000 jobs);
- Greater Manchester (15,000 jobs); and
- Bristol (11,000 jobs).

The general insurance broking and insurance agents sector comprises of around 116,293 of the overall number employed.

Figures for 2015 showed that 20.4m UK households had contents insurance, 20.1m had motor insurance and 17m had buildings insurance.

In 2013, the UK general insurance industry generated £50.2bn of net premiums worldwide and paid out £32.1bn in claims, resulting in an underwriting profit of £1.4bn (after outgoings such as commission and expenses). The London International Market writes around £40bn of foreign business across a broad range of classes, including sector leadership in marine and aviation.

Insurance Age reported in August 2015 that the general insurance broking market had dropped 2.5% each year since 2010. The value of the non-life insurance broking market hit £4.6bn in 2014, an increase on the £4.5bn recorded in 2010, but a decrease in real terms of 2.5% a year.

General insurance brokers contribute 1% of GDP to the UK economy and just under 2,000 regulated firms (employing more than 100,000 staff) have BIBA membership. Brokers arrange 72% of all general insurance with a premium totalling £62.7bn and 93% of all commercial insurance business (BIBA June 2018).

Research exercise

Consult the latest version of the ABI's key facts book for a wide range of information and statistics on the UK's insurance industry at: bit.ly/2Sb3l9J.



Some factors to note:

- Brokers' share of commercial lines remains stable, but has dropped slightly in recent years from around 79% to 72% as noted by BIBA. This figure may be understated, as business that is described as 'direct', e.g. local authority business placed with an insurer like Zurich Municipal, will often have a broker acting as a consultant.
- Brokers' share of personal lines is somewhat lower at 36% of the overall £8.4bn market (BIBA, *Manifesto 2016*).
- Price comparison websites (aggregators) have changed the face of the distribution channel in relation to personal lines business as we can see from the figures quoted above. Aggregators in personal lines distribution are supported generally by direct insurers selling their products. Aggregators' dominance is not reflected in commercial non-life lines business, which is dominated by the specialist broker. The commercial online offering is also generally supported by brokers that have been specifically structured to write the business with aggregator companies, e.g. Simply Business (which is used by Moneysupermarket.com and Gocompare.com) and has been acquired in March 2017 by Travelers Insurance company (a US organisation) or Towergate Underwriting (which works with Comparethemarket.com and Confused.com). The trend is

beginning to change and we are now seeing more direct insurers entering this space for the non-complex commercial business products.

- In relation to affinity business, brokers undertake a very high percentage of placements; around 80% of business is placed through a broker. This market is widely spread across the broker marketplace due to the diversity of the affinity businesses' trade sectors and the different requirements of each affinity or membership business.

A2 Direct distribution and price comparison websites

The growth of the direct channel and the recent emergence of price comparison websites (aggregator) has seen brokers' share of the household market fall to 20% and private motor to around 35% (Association of British Insurers (ABI)). Aggregators account for 56% of new car insurance business and are an increasing trend in household and travel insurance. However, the introduction of the **Consumer Insurance (Disclosure and Representations) Act 2012** (CIDRA) (which came into force on 6th April 2013) presented challenges, as the onus is firmly on the aggregator to ask relevant questions on behalf of all participating insurers.

Aggregators are widely used although how clients use them varies – purchasing online, just benchmarking or continuing to use other distribution methods – depending on factors such as the product purchased and the appetite to buy through this method.

Research undertaken by the FCA indicated that consumers were price-focused when using an aggregator and some mistakenly believed that the extent and quality of cover for the core policy were largely the same regardless of price (sometimes believing that only add-ons and/or policy excess amounts signified differences in the level of cover). Aggregators' own data supported this price focus.

The FCA also found that aggregators present the price of the core product more prominently than other information provided. This approach, combined with the shortcomings in information provision, leads to a large number of consumers buying the cheapest product (even where this may not be the most appropriate). The focus on price exacerbates the practice by providers of stripping out features from the core product to be price competitive and to appear at the top of the quote rankings.

Refer to

Refer to [Price comparison websites \(aggregators\)](#) on page 2/11 for further discussion of the FCA's research into aggregators

Where traditional brokers retain their dominance is in the commercial sector, although this has dropped slightly from around 85% in 2016 to around 79% in two to three years. The declining trend seems to have plateaued somewhat. However, given the speed of tech innovation in the market, it only takes a single disrupter to become a catalyst for further movement.

In 2016, there were 5.5 million businesses in the UK. Over 99% of businesses are small or medium sized enterprises (SMEs), employing fewer than 250 people. 3 million (96%) of SMEs were micro businesses, employing up to 9 people. Micro businesses accounted for 32% of employment and 19% of turnover according to the House of Commons Library Briefing Paper, 23 November 2016.

Micro businesses are more likely to source insurance products online as they are used to purchasing other business supplies through this method. Brokers may face further challenges from the appetite of micro businesses using this distribution method if insurers choose to simplify online purchase by standardising 'fair presentation' to a set of questions.

Brokers are also questioning the viability of the work and the commission earnings that will be needed to cover their costs to broke a business of this size to insurers. Will this push up premiums or just push the micro business to purchase insurance online? The **Insurance Act 2015**, which introduced changes to the duties of both parties to a non-consumer contract in respect of the provision of information, could change the buying behaviour of the micro-business owner.

On the Web

The full House of Commons Library Briefing Paper, 23 November 2016:
researchbriefings.files.parliament.uk/documents/SN06152/SN06152.pdf.



Throughout all this, the broking sector has remained intensely competitive. The forces described above have resulted in a landscape that in some respects has changed radically, yet in others retains essential qualities that would be familiar to a practitioner starting out at any time in the past 50 years.

A3 The London Market

The London Market is the largest international market in the world; it employs around 48,000 people, contributes some £60bn to the UK's GDP and places business across a wide range of specialist classes. This business is split roughly 60% Lloyd's and 40% London-based companies and provides capacity for the UK and international markets. Risks come to London for the following reasons:

- Risks where London leads in expertise – these include marine, aviation, satellite, offshore energy and fine art covers.
- Risks that tend to be declined by local markets – in the UK, London will often offer capacity for high-risk trades such as nightclubs, scaffolders, so-called 'bluelight' motor risks (the emergency services) and non-standard construction.
- For foreign risks, London provides capacity, extensive technical knowledge and resources.
- Insufficient local capacity.
- Innovation and rapid response to new risks.

Lloyd's of London is part of the broader London Market. It accepts business from over 200 territories worldwide and has licences in 75 territories. It has 83 syndicates, 56 managing agents, 3797 coverholders and 287 brokers. It handles £34bn of premiums and directly employs nearly 1,000 staff (Lloyd's, Annual Report 2017).

In the aftermath of Brexit, the Chairman of Lloyd's, John Nelson announced: 'The decision of the UK to leave the European Union has obvious implications for the market and our business with Europe. Finding the right solution has been a top priority over the last nine months. I am pleased to report that we have recently announced our intention to establish a subsidiary in Brussels during 2017.'

Chairman of Lloyd's, John Nelson Lloyd's Annual Report. Page 4.

You can access Lloyd's Annual Reports archive at: bit.ly/2PJ8QF9.

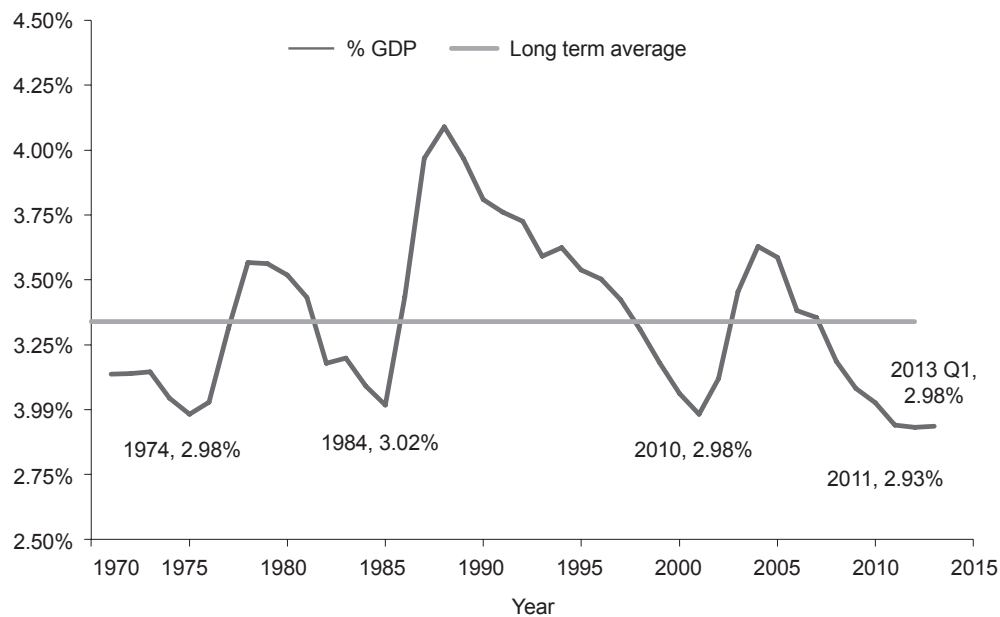


B The insurance market cycle

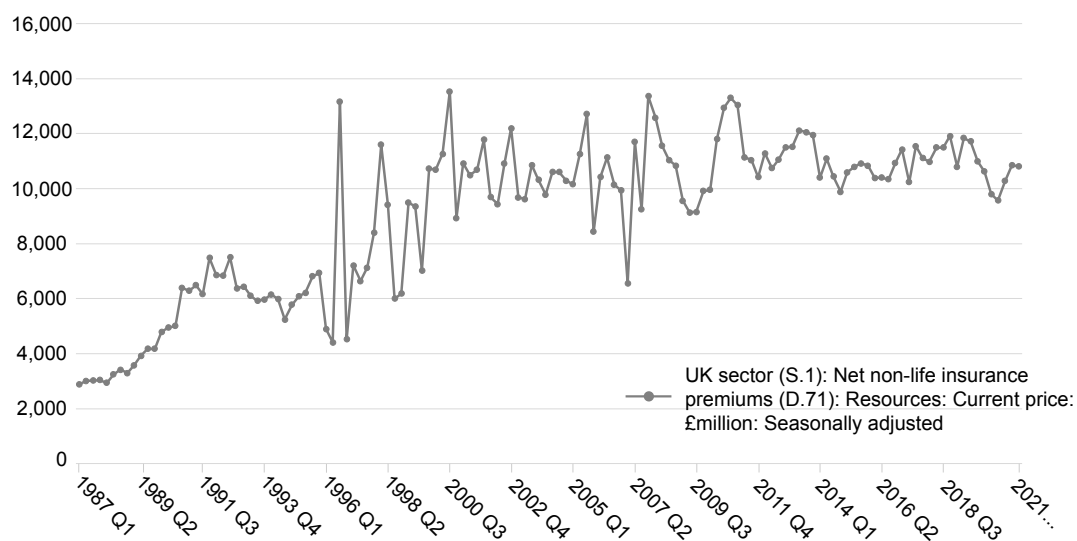
As you should already know, the insurance and reinsurance *market cycle* is the trend for rates and capacity to rise and fall over time, often independently of the general economic and business cycle. Periods of rising rates and shrinking capacity are known as a '**hard**' market and the reverse a '**soft**' market.

Figures 1.2 and 1.3 illustrate the market cycles in the USA and the UK. They show respectively the ratio of net written reinsurance and commercial premiums to gross domestic product (GDP). This eliminates the confounding factors of growth and inflation to give a proxy for the state of the market. Figure 1.2 is derived from net reinsurance premiums, which are more volatile, and so the changes are more pointed than those in figure 1.3, which are derived from UK commercial premiums. The latter tends to be flatter as it includes SME premiums, which are less volatile than those for larger risks.

Of course, the entire market does not change at the same time. There are different cycles around the world and in the different classes such as aviation, space, hurricane in the Caribbean and South Eastern US, energy, direct insurance versus reinsurance, and so on. The swings of the *market cycle* also tend to be more pronounced in the 'Anglo-Saxon' economies. In the past, market observers have suggested a cycle length of between six and seven years—yet this is not evident from figures 1.2 and 1.3.

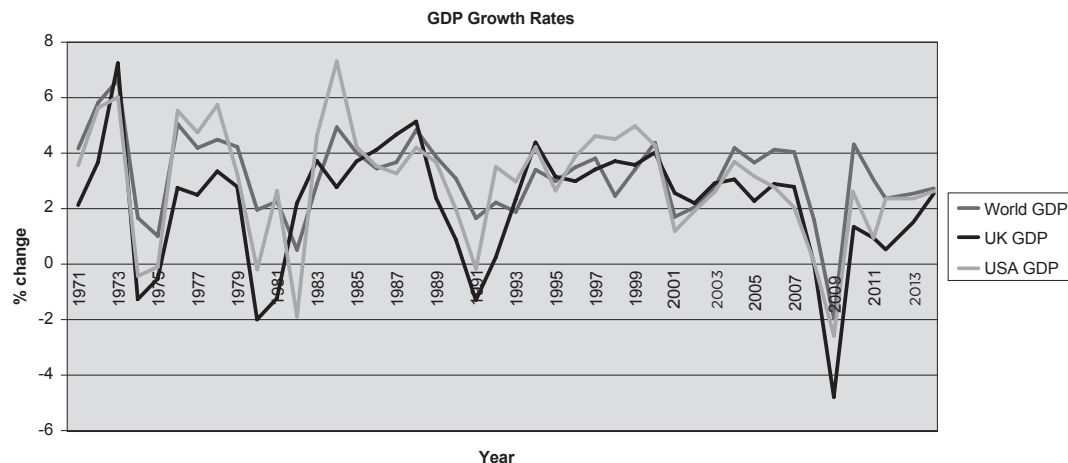
Figure 1.1: US reinsurance net written premium as a percentage of GDP

Source: Aon Benfield Re, reproduced with kind permission

Figure 1.2: Commercial premium/GDP

Source: ABI/HM Treasury

We shall look at some of the specific drivers of the insurance market cycle below. However, first we should remember that most economies are cyclical in nature. Figure 1.3 shows world, US and UK GDP annual growth rates since 1971.

Figure 1.3: World, UK and USA GDP annual growth rates

Source: World Bank; Annual percentage growth rate of GDP at market prices based on constant local currency. Aggregates are based on constant 2005 US\$.

The volatility of GDP growth is clear with the particular example of the sharp dip following the 2008 financial crisis. The causes of this volatility are outside the scope of this text but include factors such as supply and demand, technological change, energy prices, population change, the level at which governments set public expenditure and borrowings and whether they run a budget surplus or deficit.

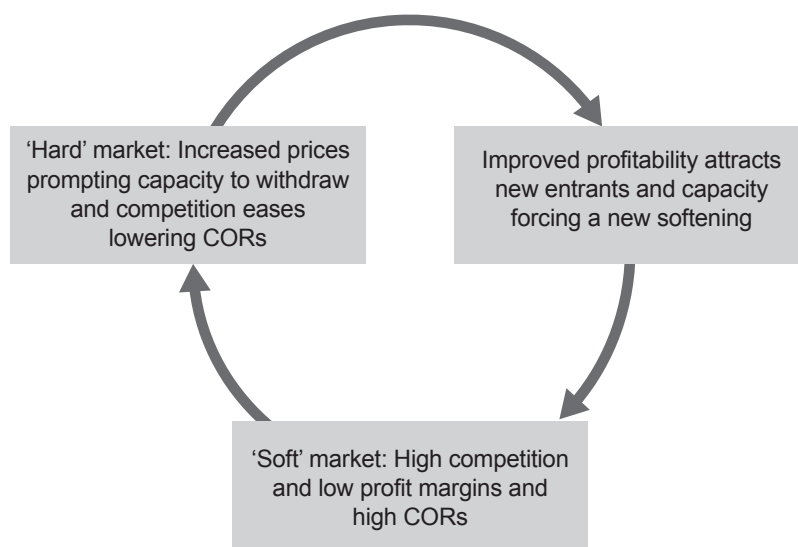
It would therefore be surprising if insurance premiums did not in some way reflect the business cycle. Indeed all of these factors affect the demand for and the price of insurance.

Research exercise

Research and find the latest economic trends data and consider how these aspects of the economic cycle might affect the demand for insurance?



A simplified version of the theory of the insurance market cycle is that insurers will sustain underwriting losses for some time because they can rely on the 'float' as Warren Buffet of Berkshire Hathaway describes it. The 'float' is the difference between the premium received and the claims that will be paid subsequently often years later. The insurer can invest the 'float' advantageously. This is the soft period. Of course this only works if the claims do not exceed the sum of the premium and investment income.

Figure 1.4: The market cycle

Note: COR refers to combined operating ratio.

When losses begin to exceed the investment returns, eventually the losses become unsustainable as they exceed earnings and start to destroy capital. This causes a change in sentiment and insurers either stop writing particularly loss making business or drive rates up, sometimes rapidly. This is known as the hard phase – the increased rates lead to increased profits. More capital is then attracted back to the market and the resulting increased competition leads to a soft market, and so the cycle continues.

However, this does not provide a complete explanation for market behaviour. For example, the World Trade Center disaster was a significant loss at around \$35bn and led to a very hard market in many classes of business with some rates increasing by more than 500%. Yet in the first half of 2011, the market saw total catastrophe losses in excess of \$50bn and rating has hardly moved (outside the markets for catastrophe cover).

To understand the cycle better and to identify what might indicate a change in the market, we need to look at some of the key drivers.

Insured catastrophe losses such as the World Trade Center (WTC) disaster in September 2001 or the widespread UK flooding in the summer of 2007.	Note the qualifier 'insured'; many disasters have significant uninsured costs even in the more developed economies, e.g. the insured value of the Tohoku earthquake in Japan in 2011 at around \$25bn was less than 10% of the economic damage.
The market for catastrophe cover is also affected by whether these losses are becoming more frequent or whether their cost reflects the increased exposures as a result of growth in population, values and the economy generally.	
Claims cost inflation, which is driven by a combination of:	• a greater propensity to claim—the 'compensation culture' as it is known; • advances in medical science that enable injured and ill people to live much longer; • increased cost of providing medical treatment; and • legal costs inflation.
Problems such as the huge cost of litigation and compensation for asbestos-related injuries, estimated by some observers at over \$250bn over the past 25 years.	
Events that affect the asset side of insurers' balance sheets, such as volatility in the value of equities or bonds held by insurers as investments.	
The beneficial effect of risk management activity that reduces the frequency and cost of losses—these serve to reduce premiums.	
The availability of capital.	Insurers compete for capital along with all other businesses.
Rapid capital deployment by investors when they perceive above average returns to be available from (re)insurance.	Taking the form of new insurance companies rapidly formed in favourable domiciles, e.g. Bermuda, or 'sidecars' (special purpose capital vehicles), that share in an existing insurer's risks enabling it to write more business.
The oversupply of insurance capacity, especially for 'ordinary' or 'standard' risks.	Perfectly demonstrated in the private motor market where there is intense competition for good risks, often defined as a family of four driving a mid-powered, mid-size saloon, resulting in lower premiums. The market for young drivers or the owners of high-performance vehicles is much narrower and more expensive.
In many Western economies, the effect of oversupply is made worse by a limited growth in demand.	The result of both relatively low growth rates in their economies as a whole and the fact that in many developed economies, the vast majority of businesses buy insurance (because the law or their financiers say they must) leaving little scope for insurers to find uninsured businesses. There are exceptions, e.g. the UK Public Private Partnerships (PPP) where state infrastructure, such as roads, schools and hospitals, are built and operated by the private sector with private finance.
The way insurance companies manage risk within their business through the use of technical and actuarial pricing models, catastrophe risk modelling and conservative investment strategies.	



Consider this...

Consider other markets and industries to see if you can identify other examples of cyclical behaviour and the factors that drive it.

To put some of these factors in perspective, we shall look briefly at the causes of the hard markets in 1975 to 1977, 1985 to 1987 and in a little more depth at 2001 to 2003. The 1975 to 1977 hard market was unique to the USA and was one of the first real manifestations of

the impact of the US legal system. Medical malpractice insurance had become very difficult as a result of the weight of litigation against doctors, nurses and hospitals.

The 1985 to 1987 hard market was again the product of the US legal system which had turned its attention to product liability. The result was a series of decisions that were extremely adverse for manufacturers and their insurers. Premium increases for risks with US exposure were between 500–1,000% and the period saw the introduction of new exclusions of pollution and punitive damages as well as a severe reduction of capacity and the application of claims made cover for risks that had traditionally enjoyed the occurrence basis.

This was also the era when litigation related to environmental pollution and asbestos began to accelerate. One outcome of this episode, the increase in the cost of liability premiums, was the formation of new Bermuda-based excess casualty insurers Ace and XL who had gone on to become global composite insurers in their own right and were subsequently bought by Chubb and Axa, respectively. The rapid formation of new capacity was to become a feature of subsequent harder market periods.

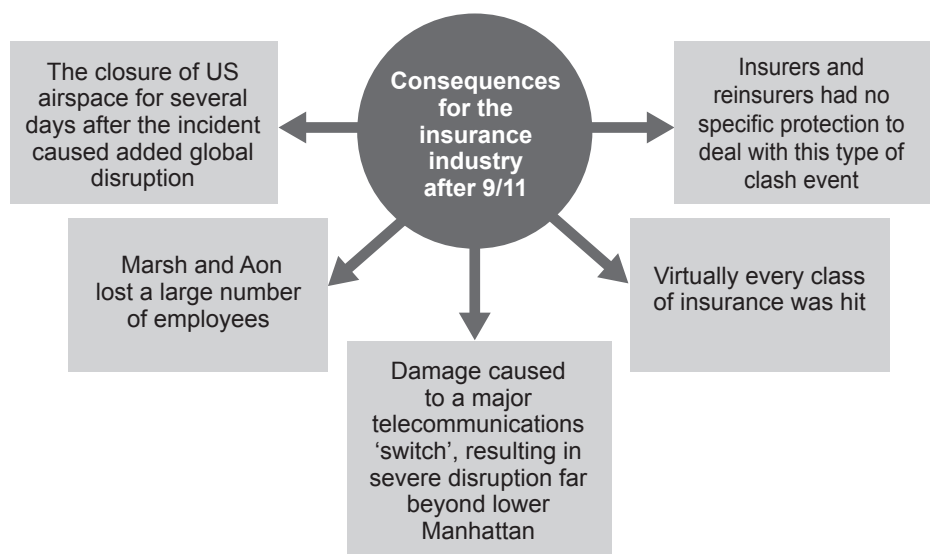
In both of these examples, the abrupt hardening was the result of a specific cause. The same argument might also be made for the 2001–3 hard market that is of course associated with the World Trade Center (WTC) disaster. There is no doubt that the impact of 9/11 on the market was profound. Aside from the technical issue that it was the first catastrophe loss to affect nearly every line of insurance and reinsurance at the same time, there was the profound shock of the event and the loss of life. Many of the dead worked in the insurance sector.

However, there were other forces at work that combined in a unique way. During the 1990s, there was a long period of softening of rates that had begun around 1985. In the words of the Insurance Insider, reinsurance market competition between 1998 and 2000 was 'near suicidal'. The result was underwriting losses that exceeded investment income.

The long soft market that ran until the turn of the last century meant that most insurers' results were less than sparkling as far as the investors were concerned. This was the time of the telecom, media and technology (TMT) boom, also known as the first internet boom, and the analyst community regarded insurers as pedestrian compared with the dynamic technology stocks they were promoting on the basis that the boom would never end.

Insurers, finding it difficult to match the attractions of the stocks themselves, decided that the best way to join the party was to invest heavily. Of course they were not alone in this and along with every other investor saw the value of their investments crumble in the bust following the boom. As with individual investors, this meant a serious loss of wealth with resultant damage to the asset side of many insurers' balance sheets.

This was the backdrop for the WTC disaster on 11 September 2001. As we have said, while this was by no means the most expensive catastrophe, it had a number of characteristics that sent shockwaves through the industry:



As Warren Buffett pointed out shortly afterwards, (re)insurers had made a 'fundamental underwriting mistake by focusing on experience, rather than exposure, thereby assuming a huge terrorism risk for which we received no premium'.

Thus there was an unfortunate combination of poor profitability as a result of the long soft market, the capital hit to balance sheets as a result of the fall in equities, and the profound psychological impact of the WTC disaster.

As a result, the market was incredibly disrupted through the last quarter of 2001 and the first half of 2002. Some lines of business experienced a massive loss of capacity and rates increased across the board with the worst hit risks receiving increases ranging from 50% to 500%. This caused much distress among many clients, particularly as there was, in many cases, no direct link between the increase and claims experience. This naturally damaged the credibility of insurers and brokers.

The UK of course had its own problem with the collapse of the Independent on 17 June 2001. Although primarily a UK insurer, the Independent wrote a considerable book of foreign business through its London base. The UK market had already started to slowly harden earlier in 2001 and the failure of the Independent caused a huge volume of 'underpriced' business to flood the market. The WTC disaster was the final turn of the screw.

We have seen further recent insurance company failures, these being Gibraltar-based unrated insurers. Enterprise Insurance ceased trading in July 2016 and Gable Insurance went into liquidation as of 17 November 2016. Similar to the Independent collapse, underrated business flooded back into the market.

Before we look at the consequences of this market and the actions taken by insurers, we need to emphasise that the review above looks at the broad sweep of the market and is focused on the UK and the USA, although the impact of the 2001 to 2003 hard market was felt around the world. As was said above, there are various market cycles. For example, the 1994 Northridge earthquake caused some \$15bn of insured damage in uninflated dollars. Although hardly registering in figure 1.6, it had a profound impact on the property catastrophe market and led to the formation of much new capacity in Bermuda.

A decade later, Hurricane Katrina caused insured damage in excess of \$50bn (uninflated) and the market for hurricane damage in the Gulf of Mexico quadrupled in cost the following year, but with virtually no impact outside of that market. Indeed, as with other hard periods, rates had already begun to fall some two years later.

All of these events, but particularly the WTC disaster and the TMT bust, led to profound changes within insurers, including:

Investment strategy	The direct impact of the fall in equities was for insurers to adopt a risk-averse investment strategy away from equities towards cash, government stocks and so-called highly rated commercial paper (bonds issued by public and private companies).
Pricing models	Although all (re)insurers had worked to rating structures these were considered to be relatively unsophisticated. New technical pricing models were developed with considerable actuarial input. These enabled (re)insurers to know with greater precision where individual risks lay against the portfolio overall and the impact of individual rating decisions.
Catastrophe models	The WTC disaster gave a tremendous impetus to the development and sophistication of these models. Large risks and any risk in a designated 'cat' zone are now only underwritten once the relevant data has been entered into the (re)insurer's model, the maximum exposure to an event calculated and the appropriate capacity authorised and allocated.
Greater underwriting discipline	Systems and controls introduced, and more determined enterprise risk management.
Cover withdrawn/greatly limited/separately underwritten	E.g. terrorism and business interruption (BI) extensions for risks away from the insured's premises.

Despite these changes and with much talk of a 'paradigm' shift within the industry with the abolition of hard and soft markets, by the summer of 2003 rates had generally begun to fall. In retrospect, this may be easy to explain. Once the shock of the WTC disaster had passed and with the changes described above, confidence returned no doubt aided by the exceptional profits that most insurers had made in 2002 and were to make over the next three years. There was also a recognition that in the whirlwind of the hard market and 'book

correction' (a euphemism common among underwriters for removing the 'lower quality' risks that had been underwritten in the previous soft market) there had been an overreaction and that some risks were just paying too much. And so the cyclical downturn began, as illustrated in figures 1.3 and 1.4.

The difference now was that insurers and reinsurers had a much better grasp of their underwriting and their accumulation exposures. So although at first some and then later more of the market became competitive, they had a much better idea of the impact on the portfolio. And unlike the banks, there was no pretence that the models, both pricing and catastrophe, were perfect and judgment was still an essential component in underwriting.

An ironic consequence of the greater prudence of insurers came with the 2008 financial crisis. As banks were bailed out, nationalised and otherwise gifted taxpayers' money, the insurers stayed in business. There were a few wobbles but broadly, the insurers had avoided the exotic financial instruments that played a key role in the financial crisis.

There was of course an important exception in the form of AIG, which was in effect nationalised by the US government. At the time, the property and casualty underwriting business of AIG was the largest in the world. The reason why AIG had to be rescued lay in the Special Products division that wrote the credit default swaps (CDS) and the collateralised debt obligations (CDOs) that were to be the source of the problem. The AIG insurance companies had virtually no direct exposure to these instruments since they had adopted the conservative investment strategy described above and indeed, their assets were effectively 'ring-fenced' from the rest of the business.

Meanwhile, the general soft market continued. Even the directors and officers (D&O) market, which started to tighten for financial services risks as a result of both the financial crisis and the Bernie Madoff scandal, resumed normal business by 2010. So the insurers having learnt their lessons from the TMT collapse and the WTC disaster managed their businesses well and received little reward. Indeed one of the main talking points amongst industry leaders currently is the overall discount to asset value of most publicly traded insurers' shares and the need for further consolidation amongst (re)insurers.

Critical reflection

Why do insurers persist in business if the returns can be so poor, volatile or indeed loss making? This is an area that candidates should research for themselves. You should consider, for example, the:

- long-term nature of insurance;
- investments made by insurers in distribution, underwriting systems and other essential components of a business;
- 'guaranteed' nature of the demand for insurance; and
- huge complexity of closing down an insurance business.



So we can draw the following conclusions:

- In the past, extreme hard markets have been driven by specific events often aggravated by long periods of falling rates leading to less profitability. They are often limited to one class of business.
- 2001 to 2003 was exceptional in that the whole market, every class of insurance, hardened at the same time.
- A characteristic of hard markets is overreaction at the individual risk level. This is probably what leads to their short-lived nature.
- There is an underlying cycle that follows a trend of underwriting losses leading to increased rates followed by more capital being attracted to the market that leads to oversupply, reduced rates and eventually underwriting losses.
- Insurers' investment strategies and underwriting systems enable them to control risk better, make them more resilient to shock events like the 2008 financial crisis, but may have the effect of reducing the likelihood of periods of severe hardening.
- Following the financial crisis, one consequence of a more conservative investment strategy has been a reduction in investment returns, because with low risk comes low return.

- The risk of insurer failure, at least in the UK, has been reduced by both insurer systems and the governance introduced both by UK regulation and **Solvency II Directive 2009/138/EC**.

Some final thoughts on why the insurance cycle persists in a way is not true of other sectors. First, the private sector has cycles of economic activity, driven by forces that are similar to those driving the insurance cycle.

However, that cycle applies to the aggregate of business activity, growth and recession. However, within the business cycle, there is considerable change. Later in the course, you will find a table that compares the world's twelve largest companies across a period of time. What is self-evident is that while a few businesses survive many simply fail or are eclipsed by new entrants and technologies. The difference with insurance is that the basic principle that the losses of the few are shared amongst the many still works and so far has not been supplanted by an alternative.

The internet or smartphones may bring new forms of distribution, but the product remains the same. This of course, is both a strength and a weakness. The strength is that survival is guaranteed, the weakness is the cycle that paradoxically may have become more embedded as insurers have become better managed and more resilient.



Research exercise

Investigate the different experiences of hard and soft markets in the UK and Europe, and consider why the markets behave differently. What impact has Covid-19 had on the markets?



Research exercise

Investigate the changes in the composition of economy over the past 50 years. Did Ogden have a substantial impact?

B1 The impact of the cycle on insurance brokers

Where a broker makes its revenue from brokerage or commission and other payments that are premium-dependent, the most obvious impact of the market cycle is on the broker's income. While hard markets might bring welcome increases in brokerage, they also result in disgruntled clients. Also, as we have seen above, hard markets tend to be short-lived and the broker may see a long period of declining income as rates fall. As an example, there was a period in the early 1980s when the UK property market became particularly, some might say absurdly, competitive. It was not unknown for premiums for a given risk to fall by as much as 60%. That is the amount that the broker's income will fall by as well. There are few businesses that can deal with that kind of change without severe stress. How brokers dealt with this volatility is looked at later in the section on broker remuneration.

You should now start to think about the impact of market volatility on brokers' earnings, in advance of working through the discussion on fee v. brokerage that features in chapter 12.



Consider this...

How do you think that the market cycle affects insurance brokers?

C The role and impact of brokers within the insurance market

Compared with other professionals, brokers have two major roles. Their primary, some would say only, role is to act as the agent of their client whose interests they must put before their own. You should be familiar with obligations placed upon the broker in the role as agent, but to recap:

Table 1.1: The key features of the broker's agency relationship

Implied or written	The <i>agency</i> can be implied and evidenced by conduct or written, but all modern agency agreements are written.
Lawful instructions	Agents are required to follow the lawful instructions of their principal provided that they are not contrary to the law or regulation.
Skill and care	Agents must exercise reasonable skill and care in carrying out their duties.
Fiduciary obligations	Agents stand in a fiduciary relationship with their principal and must not use their position for their own benefit, and must keep a proper record of all transactions.
Conflict of interest	Agents must always act in their principal's best interests and must put these interests first. Any actual or potential conflict of interest must be disclosed to and agreed by the principal.
Secret profits	Agents cannot make secret profit from their principal, e.g. by payments from other suppliers. Any profit is payable to the principal. Brokerage is deemed not to be a secret profit as it is regarded as standard market practice and a matter of common knowledge.
Confidential information	An agent is prohibited from making use of any confidential information acquired in the capacity of agent either for personal benefit or for the benefit of a third party. The exception is where the agent needs to use the information in order to carry out the principal's instructions.

As you work through the course, you may discover market practice that appears to contradict the broker's agency relationship.

As you should also know from previous learning, the key aspects of the broker's role in acting as the agent of the client are to:

- **understand** the client's business, its risk and insurance needs;
- **design** and source the most appropriate insurance cover, explain the options and give reasons for the advice;
- **negotiate** cost, cover and other terms that meet the client's needs;
- **execute** the client's instructions in an efficient manner;
- **explain** the needs and the behaviour of the market to clients;
- **maintain** effective relationships with the market in order to achieve the best results for the client;
- **negotiate** claims; and
- **administer** all aspects of the transaction in an efficient manner, including maintaining the necessary records.

In carrying out these tasks the broker has to put the interests of the client before themselves and insurers. Inevitably, this can lead to a potential conflict with the broker's other 'de facto' role, which is acting as a channel of distribution for insurers and other suppliers such as premium finance companies. Some of the responsibilities the broker performs in this capacity are to:

- **understand** the risk appetite of an insurer;
- **present** risks in an efficient fashion so as to obtain the right terms quickly;
- **build** relationships with insurer personnel so as to ensure the right terms for the broker's clients;
- **place** sufficient premium with an insurer to meet its minimum requirements; and
- **act** for insurers and other capital providers where the broker has delegated authority to underwrite risks or settle claims.

The challenges and the potential conflicts between these roles will be developed as you work through the course. For example, many brokers derive not only brokerage from placing business, but also other forms of remuneration that may not be transparent to their clients.

A key challenge for brokers is the lack of experience of many staff in dealing with hard market conditions. The events of 2001 (Independent collapse and the WTC disaster) had a sudden and significant impact on market pricing and capacity. Many brokers have consolidated and have allowed experienced staff to leave the business, supported by new pensions legislation in 2015.

The skills required in a hard market are very different to those in a soft market as the focus is on negotiation skills and market knowledge. Insurers become less willing to provide blanket wordings and high limits, and these become bargaining tools for the broker in tailoring the cover to meet the client's specific requirements.

The increase in Insurance Premium Tax from 6% to 9.5% in November 2015 (and further increases to 10% and now 12%) all had an impact on market pricing and is likely to influence clients' purchasing philosophy. Furthermore, the introduction of the **Insurance Act 2015** (which came into effect on 12 August 2016), the introduction of the General Data Protection Regulation (GDPR)/Data Protection Act 2018 (DPA 2018) (which came into effect on 25 May 2018), the Senior Managers and Certification Regime (SM&CR) and the Insurance Distribution Directive (IDD) all affect the way business is handled by insurers and brokers, adding to the handling costs and training for individuals. This will be discussed further into this course.

C1 Impact of brokers on the market

In the UK, brokers place the majority of commercial business and a significant share of personal lines business. As you will see, these shares will always be subject to competition, but they are relatively static. Brokers are therefore in a position to exert considerable influence over the market.

Some insurers believe that brokers, through their competitive activity, exercise downwards pressure on premiums and are therefore the cause of the market cycle. In turn, some brokers believe insurers enter markets when they have over capacity which in turn pushes downward pressures on the market. However, this is the natural result of competitive activity in a free economy. Insurers participate in the process since they also wish to grow. In an economy with relatively low rates of real growth, this can only be done by taking business from other insurers. Indeed, when there is a change of broker, particularly on service grounds, the insurers often retain the business. Thus the cost of competitive activity tends to fall more heavily on the broker.

If brokers put pressure on premiums, they are only doing what their clients expect. Ask any business, especially in times of *recession*. If you think back to the analysis of the market cycle above, while it is clear that brokers must have an impact, there are greater and more dominant forces at work.

Inevitably, the broker's duty to put the client first and obtain the deal that offers them the best value takes precedence. In many cases this may mean the cheapest deal.

An important issue that has an obvious impact is whether a risk should be marketed every year. Some SME clients insist that they should always have the lowest price and expect their broker to do their bidding accordingly. In extreme cases, clients of this type may also put their broker under frequent competition and may change broker often. The challenge for the broker is that in practice this may not achieve the best deal for the client.

The reasons for this are summarised here:

Argument	Counter-argument
It is more costly for the broker to engage in a widespread market review each year. Although the client may view this to be the broker's job, most businesses operate on the basis of some degree of stability over time, otherwise the cost of doing business becomes too high.	There is a contradiction here in both broker competitive activity and the behaviour of aggregators and direct insurers. Most attacking brokers will normally offer to save the prospect money and the message from all personal lines advertising is about reduced premiums, savings and offering to beat other quotes by a given margin.
Insurers prefer long-term relationships with their clients – their existing clients that is. They tend to forget this when they are offering a competing quote.	Nonetheless, insurers have the same economic issues as brokers and need to defray their costs. The way most insurers are run now tends to make the quoting process relatively expensive and time consuming and they tend to want to invest their effort where they have a reasonable chance of success. A risk shown to them every year will not excite that interest.
From the perspective of the holding insurer, they are likely to take defensive action by, e.g. delaying renewal terms until as late as possible or refusing to quote terms until they know what they are competing against.	Of course, this contradicts, at least in theory, competition law, but few clients are likely to go to that extreme. They are more likely to simply move the business. See Competition law on page 6/31, for coverage of competition law.
The issue of continuity. Most insurers are more likely to entertain a borderline claim or be more flexible where there is a disagreement on the amount of a claim, if they have some form of continuity and/or relationship with the insured.	However, an insured seeking the lowest price is likely to respond cynically by saying that insurers should pay all legitimate claims and that the broker should use their influence and leverage to get claims paid anyway. (It is also worth observing that large brokers tend to sell on leverage.)

So the broker has to decide whether they must follow the client's instructions or try to counsel them away from seeking competing terms at each renewal. In doing so, they have to weigh up the risks in being put out to review yet again and of course in maintaining good relationships with insurers.

It should also be noted that brokers dealing with consumers from 1 April 2017 will have to comply with FCA policy statement, *Increasing transparency and engagement at renewal in general insurance markets* (PS16/21). The new rules state that:

- Firms should disclose last year's premium on all renewal notices.
- Where an mid-term adjustment (MTA) has been made during the year, the premium disclosed should be the annualised premium for the previous year (excluding any fees/charges associated with the MTA) to enable a like-for-like comparison.
- Where no MTAs have been made during the year, firms must provide the original premium charged when the policy inceptioned the previous year.
- A statement should be included to remind customers to check the cover offered by the renewal is appropriate for their needs and that they are able, if they so wish, to compare the prices and levels of cover offered by alternative providers.
- In addition to the above, customers who have renewed with the same provider for four years or more should receive a message on their renewal notice informing them they could save money if they switched.
- Guidance should be given to improve the renewal process for customers, allowing firms to give their customers the information they need to make the right decision.

A further argument supporting the effect that brokers have on the market cycle can be made by comparing markets like those of the UK and the USA where brokers dominate commercial business, with those like France and Germany where they do not. It is certainly true that the swings of the market cycle are more extreme in the former countries, and indeed in other countries where brokers tend to dominate.

But this may be a problem of confusing correlation with causation. The markets where brokers predominate also tend, by their nature, to be more open and competitive. For example, although the largest commercial insurer in the UK is British, the top ten for most brokers will feature companies with parents in America, Australia, Bermuda, France, Germany, Italy and Japan. Some of these companies have significant market shares. However, in countries like France, Germany and Italy, the market is dominated by domestic

insurers. In the UK we are simply not nationalistic in our choice of insurer. As a result of this openness, the market is more competitive and dynamic.

Finally, brokers do have a positive effect through their desire to expand cover for their clients and to innovate by seeking new ways to deliver insurance or through building new insurance products in co-operation with insurers.



On the Web

FCA PS16/21 full text: www.fca.org.uk/publication/policy/ps16-21.pdf.

Conclusion

What we have seen above sets the scene for the rest of the book. The UK market is large and well developed and continuing to evolve, but suffering from the constraints of low growth over the past few years. The London Market is a world leader but faces the same challenges as all business. Brokers are a dominant force and clearly have a major impact. However, they must also face the challenges of competition, the market cycle and the changing needs of their clients. These themes will be developed through the rest of the course.



Broking management decision: The competitive market

How would you decide whether it is right to remarket a client's business every year? Take into account the needs of the client and the views of insurers.



Critical reflection

Does the openness of the UK market and the resulting competition benefit clients in the long run?

D Scenario 1.1: Predicting the future

D1 Question

You are to give a talk to clients on the outlook for the market, explaining why the market of 2001 to 2003 or 2008 will not be repeated. *Write* a draft of what you intend to deliver to your audience, bearing in mind they are your clients and not your colleagues.

D2 How to approach your answer

Key points of content

You should aim to include the following key points of content:

- The strength of insurance is that the mechanism of the losses of the few being spread amongst the many has longevity. Although there have been many changes in the way insurance is distributed, it itself cannot be un-invented.
- There has been limited growth in the main markets for insurance.
- The market cycle is the process whereby underwriting losses lead eventually to a rate correction, underwriting profits and thus more capital is attracted. This oversupply drives prices down and so the cycle continues.
- The extreme nature of the 2001 to 2003 and 2007-2008 markets was driven by a combination of:
 - a long period of underwriting losses;
 - the collapse of the tech boom in 2001 leading to huge investment losses;
 - the unusual nature of the WTC disaster where insurers had not foreseen or rated for a terrorism incident causing losses simultaneously in all major classes of insurance; and
 - 2007–2008 global financial crisis.

The consequence of the 2001 to 2003 and 2007 to 2008 markets was that:

- investment strategy became more conservative;
 - insurers managed their own risks, including accumulation, far better;
 - insurers improved their management of their own underwriting; and
 - insurers overall became more resilient.
- The consequence of these actions was that insurers survived the financial crisis and they are much better prepared for extreme events.
 - Therefore although the soft market must eventually end, when it does the harder market is likely to be short-lived and will not be as extreme as cycles of the past.

Increases in IPT, the Ogden rate and the implementation of the new FCA rules on increasing transparency in general insurance markets will see an effect of the market hardening from 2018.

Self-test questions

1. Produce a diagram showing the market cycle and explain how this operates.
2. Summarise the two key roles of the broker and give two aspects of each role.

You will find the answers at the back of the book

2

Distribution

Contents	Syllabus learning outcomes
Introduction	
A The distribution landscape	1.3, 1.5
B Client value proposition	1.3, 1.4
C Routes to the customer	1.3, 1.4
D Distribution by insurers	1.3
E Broker distribution	1.3, 1.4
F Consolidation	1.3
G Working with other brokers	1.3
H Broker networks	1.3
I Scenario 2.1: Streamlining	
Self-test questions	

This chapter relates to **syllabus section 1**.

Learning objectives

On completion of this chapter and your own private research, you should be able to:

- examine the distribution models used by insurers and brokers;
- examine the transaction of business with other brokers; and
- examine the different methods of trading with clients.

Introduction

The Chartered Institute of Marketing defines marketing as:

The management process responsible for identifying, anticipating and satisfying customer requirements profitably.

Distribution is an intrinsic part of the marketing process since there is obviously little point in producing a great service if it can't be acquired by clients economically and effectively. While this is not a marketing text and indeed the syllabus does not refer directly to marketing, many aspects of the process are an integral part of what insurers and brokers do. Indeed this and later chapters will examine aspects of marketing as they apply particularly to brokers; for example, propositions and segmentation.

Distribution can be defined as the movement of products or services from the point of origination to the end user or customer. However, these simple words conceal the many complex decisions and processes required to achieve successful distribution.

Most brokers probably don't think of themselves as 'distributors' and of course insurers and brokers have different relationships with the ultimate insured. The insurer has a direct contractual relationship through the insurance policy in which the broker normally has no legal standing. The broker is primarily the agent of the insured and must put the insured's interests above all others. However, from the perspective of insurers, brokers are a key distribution channel since they control 72% of commercial insurance (BIBA) and around 36% of personal lines business (ABI: *UK insurance key facts 2015* – 52% of personal motor insurance and 24% of domestic property insurance is purchased direct). Brokers dominate international and reinsurance business. Brokers therefore have a significant influence on the way insurers approach and manage distribution.

While brokers may not see themselves as distributors, the larger broking firms and the consolidators often define their strategy in terms of controlling the distribution of insurance as well as providing professional services to their clients. On the client side, brokers are increasingly thinking in terms of how they distribute those services to individual clients and groups of clients or affinities.

In this chapter we will consider:

- the distribution landscape;
- routes to the end customer;
- distribution by insurers;
- distribution by brokers;
- the way insurers deal with different types of broker;
- consolidation;
- methods of trading with clients;
- working with other brokers; and
- broker networks.



Key terms

This chapter features explanations of the following terms and concepts:

Affinity	Broker networks	Client value proposition	Consolidation
Delegated authorities	Managing general agents (MGAs)	Price comparison websites	White label

A The distribution landscape

The insurance distribution landscape in the UK has seen many changes. In 1985, Direct Line was the first major direct-to-customer insurer to use the phone supported by extensive TV advertising to replace traditional distribution methods, mainly via brokers. There were many sceptics but Direct Line is today one of the UK's leading personal lines insurers. The arrival of the internet and e-commerce further changed the distribution landscape with both insurers and brokers offering their products and services online. The first *price comparison websites* (aggregators) launched in 2002. These companies use extensive TV advertising and advanced technology to drive internet-based distribution, primarily in personal lines.

After a wave of mergers and takeovers among the large firms in the late 1990s, broker consolidators took advantage of cheap debt and generous commission deals available in the early 2000s to build substantial businesses through the rapid acquisition of many small brokers.

The largest consolidator, Towergate, also built a substantial **managing general agent (MGA)** and controlled some £750 million of gross written premium through acquisitions and debt financing. This pushed the organisation to collapse resulting in creditors taking control when it restructured in 2015 and wiped out approximately 60% of its debt. The group structured and restructured, creating a new broking group called KIRS holding the various Towergate Brands, and refinanced its £800 million debt with a bond deal. Eventually, in 2017, the group rebranded as Ardonagh.

In addition to the rise of the aggregators and the continued process of consolidation, many other factors have had a significant bearing on distribution and marketing for both insurers and brokers, including:

- the sheer competitiveness of the industry;
- greater demand from large- and medium-sized clients for a wider and more sophisticated range of products and services;
- prolonged soft commercial insurance market conditions with few expectations of change, although following significant losses particularly in the property market rates started to harden back in 2018 and continued into 2019 and 2020;
- lack of real growth in the private sector of the economy for many years, although 2014 saw a return of market confidence with companies starting to invest in construction and business projects which continued for the next 5 years;
- the continuing trend towards fees for broker services for mid-market clients;
- 'claims farming', referral fees and fraud, particularly in the private motor sector leading to a Competition Commission review and reputational issues for the industry as a whole – referral fees have now been banned in the Jackson Reforms, which should continue to see overall claims costs reducing and a more balanced settlement in favour of the claimant, as opposed to legal fees;
- the threat of the evolving internet and block chains to further disrupt existing business models. Alongside this is the debate that in the desire to simplify the commercial insurance transaction online, there may be a rise in disclosure-related issues;
- the **Competition and Markets Authority (CMA)**'s ruling (with effect from August 2016) on provision of information to motor insurance consumers about no claims discount (NCD) protection – the ruling is causing extensive changes to brokers' and insurers' systems and processes, and policyholder documentation;
- the fact that while the internet and other forces may change distribution methods, the underlying insurance product remains relatively unchanged proving that the model of the 'losses of the few being spread among the many' is robust;
- for insurers, the selection of the myriad alternative distribution routes;
- in the case of Lloyd's, how it manages its dependence on Lloyd's brokers;
- both insurers and brokers have to decide how physically close they need to be to their clients; do they maintain traditional multifunction branches, centralise some activities or make use of call centres?
- the 5.5m private sector businesses in 2016, of which SMEs accounted for 96%, an increase of over 97,000 from 2015 (Department of Business, Energy and Industrial Strategy). Even smaller brokers can find the economics of servicing this 'small' sector

challenging. The **Insurance Act 2015** may have an effect on how brokers place their micro business in relation to the advice provided and the fees charged. No doubt the 2020 Covid-19 pandemic will have an impact on many of these businesses that had been forced to close for long periods of time under Government guidelines.



On the Web

bit.ly/2opz4ee

Department for Business Energy & Industrial Strategy – Business Population Estimates 2016



Consider this...

Last few years has seen major disruptions within the political, economic, social, technological, legal and environmental factors in the UK and the global landscape.

How has that affected brokers business models and the overall competitiveness of the industry?

It is perhaps an understatement to say that these competing forces lead to **distribution complexity** for both insurers and brokers. Brokers want the best deals for their clients while gaining access to the right markets on the right terms. In doing this, they have to resolve their own distribution challenges through structure, size and specialisation, and the management of revenue and costs. They must put the interests of the client before the interests of the insurer. Of itself, this can lead to conflict between the interests of broker and insurer.

The Insurance Act 2015 has put onus on both the client and broker to provide a fair representation to the insurer at the commencement of contract. This therefore will require consideration of the level of advice provided by the broker and the cost to execute that advice.

In the same vein, insurers wish to retain business for the long term and charge premiums that enable them to achieve their desired return for their investors. They are required to undertake the fair treatment of customers but this does not oblige them to provide the lowest price or the widest cover.

So today's distribution and marketing landscape is dynamic and complex. Insurers and brokers face difficult choices in order to find profitable growth in a market that is highly competitive and growing slowly.

B Client value proposition

Both insurers and brokers are concerned about responding to the needs and wants of their clients. This aim is often defined in terms of the *client value proposition*. Essentially, this is how the offered services and products respond to the client needs and wants. The client has a problem and the proposition is the solution. The proposition is therefore defined, for example, in terms of:

- the demographics of the client marketplace;
- the location of clients;
- the specific needs and wants that reflect their individual characteristics;
- how the products and services offered respond to these needs and wants or how they need to be adapted or tailored to do so;
- how it will be delivered and where from; and
- the cost of providing the proposition.

The client value proposition is therefore an important part of distribution.

Consider this...

How might the respective 'propositions' of a motor insurance offering of a direct insurer and a high street broker be defined?



C Routes to the customer

Table 2.1 summarises the many routes to the end customer for both insurers and brokers.

Table 2.1: Routes to the end customer for insurers and brokers

Route	Insurer	Broker
Direct	• Potential for conflict with brokers. • Requires investment in client relationships. • Personal sector requires heavy advertising and extensive and effective systems for fulfilment.	• Most broker business is direct to their clients, but they also need to consider: – appointed representatives. – sub-brokers. – their own version of 'direct', e.g. for affinities or 'micro' business.
Brokers	• Significant channel of distribution for both commercial and personal business. • Diversity and number is a challenge.	
Own websites	• A must-have, but issues of cost and complexity, especially for full cycle transactions. • Some sites are brochure-ware only whereas some insurers have developed full cycle quote, bind and invoice services.	• Issues of cost and complexity. • Good results can be obtained from website optimisation to attract hits from search engines. Small and large brokers deploying, but not universal.
Internet brokers	• Mainly aimed at small-to-medium enterprise (SME) business. • Widely backed by insurers.	• Originally intended to bypass brokers, but now being aimed at them.
Affinity schemes	• Attractive to insurers with a mix of direct and brokered business. • Needs a strong tie between the affinity organisation and members to be successful.	• Attractive to brokers with the right organisation and connections. • Needs a strong tie between the affinity organisation and members to be successful.
Print media offers	• Attractive to insurers where they can target the right demographic.	• Often treated like affinity. Attractive where the broker has the right connections and resources.
Print media advertising	• Widely used in both national and specialist titles. • Aimed at the corporate sector in specialist risk-based publications.	• Limited use of national titles due to expense, but specialist titles used for scheme business.
Social media	• Many insurers have pages on Facebook and other social media sites and use Twitter.	• Some brokers making extensive use, especially for lead generation. • Large brokers inhibited by tendency to restrict access to social media for most staff through corporate IT systems.
Outbound call centres	• Tends to be limited to direct insurers only and then some only use to contact existing customers.	• Some brokers have developed expertise in using this as a source of business. • Some brokers use for systematic cold calling.
Segmentation and specialisation	• Adopted by most insurers to a greater or lesser extent. • Some insurers will only write in their defined and specialist sectors. • Most insurers segment by size and class of insurance.	• Most brokers segment their business by size and class of business. • Increasing use of trade sector specialisation.

Table 2.1: Routes to the end customer for insurers and brokers

Broker networks	• Generally supported by many insurers. • Some have concerns about value for money. • One of the bigger issues in distribution in 2013.	• Smaller brokers need to assess the value. • Current membership is over 1,500. • Network operators need to demonstrate value to members and insurers.
Branches	• Most insurers operate some branches with the larger insurers having extensive networks. • Many views about the value of the physical presence and the functions necessary. • Cost, flexibility and control of underwriting are big issues.	• Most brokers see value in some form of physical presence. • In some parts of the country it can be essential to keep local business. • Should branches be 'sales' only, with technical and other support centralised?
MGAs and delegated authorities (DAs)	• Widely supported by insurers to give access to different channels of distribution.	• DAs frequently used by brokers. • MGAs less common although some of the larger brokers operate them.
Market-wide IT-based distribution	• Most insurers have supported a variety of initiatives.	• These are aimed at brokers.
Price comparison websites (aggregators)	• Issues of cost and churn. • There is the potential for conflict as some of the major sites are owned by insurers. • There is the challenge of different pricing through different sites.	• Although avoided by brokers in the past, these are now being used, especially to test pricing. • Some brokers now operate their own aggregators.
Banks and building societies	• Most large insurers have specialist partnership divisions to deal with this channel. • For personal lines, the 'white label' approach predominates. • The affinity connection may be weak. • This route has limited appeal for brokers except for more difficult risks.	• The main market for brokers is to support commercial insurance distribution by the banks. • They have a limited role in designing and negotiating personal lines schemes.
Retailers	• Presents a very competitive market with low margins. • Retailers often hire their own expertise. • The 'white label' approach predominates.	• There is limited opportunity for brokers to add value in this method of distribution.
Motor manufacturers	• Generally direct between manufacturer and insurer. • Often sold as 'free' insurance.	• Limited opportunity for involvement from brokers, although there are opportunities in programme design and consultancy.
TV advertising	• Direct insurers and aggregators are heavy users.	• High costs are associated with this route and so usage by brokers is low.
Outdoor advertising	• Direct insurers and aggregators are heavy users.	• High costs are associated with this route and so usage by brokers is low.
Workplace marketing	• Tends to be restricted to specialists in the market.	• Few brokers in this market.
Inbound call centres	• Widespread use by insurers to: – provide personal lines service; – service affinities; – provide 'white label' facilities for brokers; and – manage SME business for smaller brokers.	• Limited use by brokers in view of expense, but the consolidators and some specialist firms are making more sophisticated use of these centres.

Table 2.1 is intended to demonstrate that the diversity of the routes to the customer underlines the complexity of distribution decisions. It cannot be completely comprehensive and candidates should look for other examples.

C1 Selecting the distribution method

From the complexity described above, a whole text could be devoted to how to select a distribution method. Below, and in subsequent sections, we consider the main issues facing insurers and brokers.

Some of the factors that influence the decisions are:

Cost	- Each route has different costs. - In consumer marketing, costs are expressed in the number of people to be reached, e.g. cost per 1,000 readers of a newspaper.
Effectiveness	- Does the route reach the intended market? - E.g. advertising aimed at classic car owners is not going to work in a current affairs magazine.
Image	- Does the route match the desired branding/image qualities of the product/service? - E.g. advertising aimed at larger risks tends to emphasise innovation, security and sector knowledge, rather than taking a light-hearted approach.
Resource	- What resource does the firm have in terms of capacity, knowledge and expertise? - Does the resource match the demands of the channel?

Definitions

Affinity: a generic description of the distribution of insurance to individual clients (consumer and commercial) that have some connection with a common organisation or interest. Examples include classic car owners, gun clubs, bank business customers, franchise operators, clubs, federations and associations.

White label: where an insurer provides an insurance product and associated services that is branded with the name of another part, e.g. a retailer, broker, newspaper, and so on.

Delegated authority: the delegation to brokers by insurers for the authority to underwrite and/or handle claims on behalf of the insurer.



Research exercise

Consider the routes to market for brokers, select three that you think most appropriate and investigate the reasons that would lead a broker to choose one over the other as a means of distribution.



D Distribution by insurers

In this section, we look at some of the key distribution issues for insurers as they relate to brokers. We do not examine in detail the management and operation of the many alternative routes to the customer other than via brokers, important as these may be to insurers, apart from acknowledging that they are of interest to brokers as a source of competition.

So the key aspects considered are:

- distribution costs for insurers, particularly with respect to brokerage;
- why insurers choose to use brokers; and
- how insurers manage their relationship with brokers.

D1 Distribution costs

Distribution costs are all those costs in moving the product or service from the point of origination to the end user. Obviously, different businesses will have varying views on what counts as a distribution cost as opposed to say a head office cost.

Insurers do not have to concern themselves with storing or moving physical property. Their distribution costs include:

- Commission/brokerage and other incentives paid to brokers/other intermediaries.
- Frontline underwriting.
- The branch network.
- Field staff managing the relationship with brokers.
- Staff managing the relationship with large customers, e.g. banks, supermarkets etc.
- Staff managing relationships with key individual large customers.
- Call centres supporting sales and customer service.
- Advertising and marketing.
- Website development and maintenance costs.

This list is not definitive. Insurers do not generally publish a breakdown of costs, although the average commission and total expenses by line of business is provided in the returns all insurers make to the Prudential Regulation Authority (PRA). Expenses excluding brokerage generally lie in the range of 15–25%, but can be as low as 10% and as much as 40% when the insurer is building capability in advance of planned expansion.

In the UK, rates of brokerage vary from less than 5% for employers' liability, 10%–20% for motor to as much as 40% for some classes such as property owners, personal accident, and kidnap and ransom. Some of the consolidators were believed to have achieved rates of 45% for SME commercial combined business at the height of the consolidation boom but these are less common today.

SME business generally tends to attract higher than average brokerage in the range 25–30%. Average rates for larger SME business (total premiums for a single client between £15,000 and £30,000) lie in the range of 15–25%. For many insurers, the average or 'blended' rate of brokerage across all brokerage business is around 20–25%.

The majority of middle-market and large account business is now transacted net or at low rates of brokerage between 2.5% and 5% with the broker being remunerated by fee from the client. International and reinsurance business is perhaps more heavily biased towards brokerage, but most large businesses expect their broker to work on a fee.

In addition, most brokers and other intermediaries receive some form of incentive in the form of overrides and other contingent payments that can average around 2–3%, but as much as 10% for targeted new business. Although the large firms generally do not take overrides, many now supply various services to insurers. These equate to brokerage in the range of 1–10%.

Clearly, brokerage and other broker remuneration is a significant expense and has a direct bearing on insurer pricing. For example, for an insurer with a blended brokerage rate of say 22% and expenses of 23%, 55% is left to pay claims and make a profit for investors. That is why insurers tend to pay higher rates of brokerage for higher margin that is lower loss ratio business, typical commercial examples of which include travel/personal accident, real estate and directors' and officers' liability.

Of course, there is a presumption that paying higher rates of brokerage generally will incentivise brokers to bring more profitable business to the insurer. However, it is not as simple as that. The total premium still has to be competitive and as the brokerage is an inevitable component of the premium, if a higher rate is to be paid to attract business, the insurer may have to accept a lower margin. This can work in the short term, but not necessarily in the medium to longer term. Obviously, these numbers change for larger business as both the brokerage and distribution costs tend to be proportionately lower.

Brokerage is of course not the only cost that affects the way insurers deal with brokers:

- Large broker accounts can bring economy of scale that reduces the total cost of distribution.
- Conversely, the smaller the broker the greater the cost of support in both general relationship management and technical support, quality of the way business is submitted and so on.

As a result, insurers have invested in systems and processes that give them much better performance data in terms of:

- the total cost of delivery by different types of broker;
- retention rates;
- numbers of submissions, quote to submission ratio and bound to quote ratio; and
- the overall loss ratio, although this is always a contentious point since few brokers set out to inflict losses on insurers; of course it can become less contentious when good results trigger results based profit share.

We have focused on brokerage as a distribution cost as it is obviously important. However, the insurers have to manage all of their other costs.

Some of the issues they will consider include the following:

How...?	• ...many branches do we need, where do they need to be and do they have to be full service capability (i.e. a compliment of sales staff, underwriters, claims staff and other administration people)? • ...can the internet be used to reduce costs and deliver services to the point of sale, e.g. on broker's desktops to enable rapid quote and bind?
What...?	• ...is the right balance between a local underwriting authority that can respond quickly to opportunities and central control? • ...are the benefits and disadvantages of different distribution channels, compared with brokers?
Where...?	• ...should centralised functions be located and are real savings available from their centralisation?
Should...?	• ...the insurer stop dealing with brokers as a means of distribution because they are too expensive? • ...the insurer invest in the software products sold to brokers so that they can place products on the software system with the objective of improving efficiency, eliminating rekeying of data, getting preferential treatment from the broker and reducing costs? • ...the insurer invest in auto-rating systems for smaller business lines with the objective again of improving efficiency, eliminating rekeying of data, getting preferential treatment from the broker and reducing costs? • ...the insurer manage the relationships with brokers through dedicated field staff, in a market supposedly dominated by brokers? How are those staff allocated to brokers of different size and relative performance?

Research exercise

Although direct underwriters do not incur the cost of distributing through brokers they do still incur distribution cost. Find out as much as you can about the non-brokerage distribution costs of direct and internet-based insurers to see how they compare with the cost of dealing with brokers so you decide in your own mind why insurers make the choices they do.



Broking management decision: Why choose brokers?

Put yourself in the shoes of the manager of an insurance company. Why would you choose to distribute through brokers, despite knowing the additional costs of brokerage?



D2 Why insurers use brokers

Many insurers use 'multi-channel' distribution, that is, they use a mixture of methods to get to clients. A good example from the UK is Aviva, which has a substantial direct business mainly focused on personal lines. It also deals with brokers of all sizes, consolidators and broker networks, and has its own broker 'club' as well as underwriting products distributed by retailers, banks, building societies and other intermediaries.

However, many insurers choose either to distribute only through brokers or source the majority of their business through them. Typically this group includes Lloyd's, Bermuda-based specialist insurers and insurers like Ace/Chubb (now merged) or QBE. Some insurers will only distribute specialist lines through a small number of brokers. An example of this would be a bus and coach motor business, where a number of insurers will only trade with specialist brokers. They do this to ensure that risks are presented with the right information, because the specialist brokers understand the insurer's appetite in detail and to save them time and reduce their costs.

We have seen that brokerage is a significant proportion of insurers' total expenses. The connection between the rate of brokerage paid and business received is not necessarily linear. That is, simply paying a higher rate will not guarantee business. And in the large account sector where much business is done net or at low rates, there is no connection between the brokerage and the business received.

Research from the USA suggests that the total cost of dealing with brokers is higher. So why do insurers deal with brokers? There is a research exercise below, with ideas on how you might investigate this area yourself, but some thoughts might include the following:

- Brokers continue to dominate the commercial sector so an insurer can either 'beat them or join them'.
- It might be cultural as brokers are dominant in some economies and not others – **you should find out which.**
- In some countries, much smaller commercial business is done through tied agents, often with geographical exclusivity, but they are still paid commission.
- In the UK, although the total number of FCA-registered brokers is gradually shrinking, the sector remains dynamic, very competitive and determined to hold on to its market share.
- Although brokerage is a significant cost, professional brokers can produce an economic total cost due to their expertise and skill at client relationships.
- The margins in other distribution routes are no better and in some cases worse.
- Brokers provide the client with specialist advice rather than a non-advised service that they would receive from an insurer.



Research exercise

Consider instances where an insurer has opted to deal only through brokers. Why do you think they came to this decision? Evaluate the possible outcomes and weigh up the pros and cons from the insurer's point of view.

D3 How insurers select the brokers they distribute through

In the UK, insurers have to respond to the varied needs and methodologies of around 3,000 broking firms. Ideally, the insurer wishes to influence where business is placed, but to do this it needs to access the brokers' management team as well as individual placing brokers and client service teams. The consequence is that it is not distributing just to the broking firms but also to individual employees. Therefore, insurers have to devise methods of delivering their products to this broad community in a way that is cost effective and sustainable. This increases the complexity of the broker selection process.

Their approach varies from insurers like Aviva, Axa, NIG and RSA that trade with virtually all brokers, to Ace/Chubb, AIG and QBE that will only trade with a limited number of brokers, typically around 250–300 selected according to various criteria described below. Some insurers, particularly those based in London or overseas like HDI Global SE (HQ Germany) or Protector Forsikring (HQ Norway) for example, will only trade with national brokers. There are insurers who will only write certain lines of business through specialist and wholesale

brokers. Lloyd's generally only deals with accredited Lloyd's brokers. In reality, even the insurers that attempt to deal with all brokers do not treat them all in the same way.

Some large insurers have long-established direct commercial accounts. The examples are Factory Mutual (FM), which only writes property covers for larger businesses; Zurich Municipal, which specialises in the public sector in the UK and NFU Mutual, which specialises in the agricultural and food chain sectors. FM and NFU do work with brokers, although they do not pay commission.

Some of the features of the way insurers manage the selection of and distribution to brokers include the following:

Most insurers have an internal organisation specifically responsible for the overall management of broker relationships on either a national or global basis.	This function takes responsibility for all aspects of broker management from brokerage rates, through incentives, performance management and selection.
The general insurers that tend to deal with all brokers do so for reasons of history; they have always done it that way. Of course, this does not mean that all brokers are treated equally.	Brokers are segmented in a variety of ways including location, size, and current and past relationship. In practice this means widely varying quality of service. The firms perceived to be better performing will receive more attention from field staff and a better and more responsive underwriting service.
At the other end of the scale smaller brokers might find themselves dealing with a remote call centre. From the small broker's perspective these tend to offer poorer quality service.	A trenchant example of the way this approach works in practice is given in the quote from Ian Mantel of Manor Insurance Brokers.
The 'limited panel' insurers tend to be 'newer' insurers that believe they will get better and more economic results by dealing with limited panels of brokers.	
The 'limited panel' insurers select brokers on the basis of their 'fit': location, business mix, quality of staff, growth plans and business philosophy.	
An idea that was devised by the Independent Insurance Company, which went out of business in June 2001, is the broker 'club'	Essentially, these are groups of brokers with growing accounts deemed to be the right 'fit'; they receive better access to decision makers, more lavish entertainment, faster response to quotations, exclusive quotes and other support services. Often, they may receive higher brokerage.
Some insurers perceive that as a group, the large brokers are more aggressive in their broking style and can be less loyal, and thus potentially deliver worse results for the insurer.	Against this, large brokers offer economy of scale. Insurers generally have dedicated relationship functions for the large broking firms.
Conversely, a number of insurers and MGAs have organised themselves to offer consistent service to smaller firms or simply do not deal with national brokers.	
Accredited Lloyd's brokers, whatever their size (of course, most them are relatively large compared with the majority of non-Lloyd's brokers), can normally gain access to most London Market and international insurers.	However, the London Market is dominated by Aon, Marsh, Willis Towers Watson and JLT, which generate more than 50% of Lloyd's premiums.

Brokers respond to these forces in a variety of ways and these are considered in chapter 3.

D4 Price comparison websites (aggregators)

Price comparison websites (aggregators) first came to prominence in the UK around 2007. The leading sites today are Comparethemarket.com, Confused.com, MoneySuperMarket and Gocompare.com. Although they have the characteristics of direct insurers, they are actually brokers and are regulated as such.

The number of sites has shrunk from around seventeen recorded by the Financial Services Authority (FSA) in 2008. Their model is based around advanced internet-based search engine technology that seeks quotes either with the agreement of insurers or by attempting to 'scrape' quotes from insurer websites. They are extensive and aggressive users of TV advertising. They are paid commission for successful sales and may also receive payments based upon volume and the prominence with which certain insurer quotes are displayed. Their focus is almost totally on personal lines and such is their impact that direct insurers, like Direct Line and Aviva, now say emphatically in their adverts that their prices are not available on price comparison websites.

It is also worth noting the relationship between insurers and comparison websites as Confused.com is owned by Admiral, Go Compare is 49% owned by esure and Aviva is the second largest shareholder in MoneySuperMarket.



On the Web

The FCA conducted a thematic review of price comparison websites (TR14/11 *Price comparison websites in the general insurance sector*) and published their findings on 16 July 2014: bit.ly/WgKdQ4.

The FCA's thematic review into price comparison websites (TR14/11) identified the following:

- The websites did not always ensure consumers were given appropriate information to help them make informed decisions. The FCA is particularly concerned that consumers' focus on headline price and brand when using the websites could distract them from crucial product features such as policy coverage and terms. By failing to provide clear information, the websites are increasing the risk that consumers will buy products without understanding key features, such as levels of cover or excess, instead focusing purely on the price. While a few websites did provide this key information, the level of clarity varied significantly depending on the provider.
- The websites did not make clear their role in the distribution of the product or the nature of the service they provided. For example, some consumers mistakenly believed the website had provided them with quotes on the best policy for their individual needs, and had assessed how suitable the policy was for them.
- Some websites did not disclose that they were part of a larger insurer or broker group, which is a potential conflict of interest (and is against FCA rules). However, the FCA found no evidence these websites used this relationship to their commercial advantage.
- While some websites had taken steps to comply with their regulatory obligations, they had failed to fully implement guidance published in 2011.

The FCA set out the steps for price comparison websites to deal with these risks, and you can find full details in the report. You may wish to consider whether any difference in their behaviour is evident.

While these websites have undoubtedly had a massive impact on insurance distribution from the perspective of insurers, there has been a more limited impact on brokers. Currently, the websites focus on standard business so most proposers with high performance cars, driving convictions, houses of non-standard construction and so on are unlikely to get competitive terms or any terms at all. They also require a certain amount of effort although have the advantage that once the proposer's details are stored they can be reused.

Insurers have to consider the costs of providing quotes through the websites, which includes the need to monitor pricing as often as hourly. One of the issues for insurers is that if their pricing is too low, the websites tend to drive business to them very quickly, causing portfolio imbalance.

In addition, insurers price according to the scope of cover and the narrowest cover products therefore tend to rise to the top of the price comparison tables. This can be the source of one of the FCA's concerns that the difference in cover is not as clear as the websites claim and leads to customers buying a policy that is worse than that which they already have.

Consumers generally see these websites as quote engines that compare prices, but not scope of cover or quality of service.



The FCA

Due to the increasing use of price comparison websites, particularly by individual consumers, this remains a key priority for the FCA.

E Broker distribution

Most brokers do not see themselves as 'distributors', but regard themselves as acting primarily for their clients. Yet, from the perspective of insurers, they are de facto, part of the distribution chain. Unlike other professionals, such as lawyers and accountants who only act for their principals, brokers must also maintain an effective working relationship with insurers.

There are also some clear differences between brokers and insurers:

- While insurers differentiate themselves by the service they offer, they are essentially providing the insurance product. Brokers on the other hand are providing services and advice (*The role and impact of brokers within the insurance market* on page 1/15) to the client that often results in an insurance product being purchased by the client.
- The broker's first duty is to the client; this may conflict with insurers' interests.
- Although the contractual relationship is between the insurer and the client, the broker's relationship is often stronger.

The distribution challenge for insurers is which channel do they use to get to the end client, as we have seen above. For the broker the challenges are:

- how do they distribute their services to existing and prospective clients?
- how do they select and manage their relationships with insurers?

E1 Broker distribution to their clients

This discussion about the way brokers distribute to their clients should be read in conjunction with the segmentation and specialisation topic in *Specialisation and segmentation* on page 8/11, and broker organisation in *Broker organisation* on page 9/2. The way that brokers distribute is obviously a function of their size, geographical footprint, structure and growth ambitions. Distribution is about the way they organise themselves to deliver the best service to clients at the most economic cost. This involves many considerations.

Physical locations

Is it necessary to be physically close to clients? Smaller firms, often described as 'community' brokers, base their success on physical intimacy by being in the heart of the local business community and maintaining close personal relationships. But as firms grow larger their geographical reach extends and it is quite common for larger brokers, even where they are based in a single office, to service clients all over the UK.

All the national brokers have offices in the main centres outside London, such as Belfast, Birmingham, Cardiff, Manchester and Glasgow. Regional office networks are often the result of past acquisitions as much as deliberate choice. Some clients are sensitive to location and some are not. Many large clients expect to be serviced from London but then some believe that better service is obtained locally.

Technology now means that many jobs previously done in offices can be done from home or in central back offices located in the UK or offshored/outourced overseas (see *Offshoring, outsourcing and core competencies* on page 8/4). As a result, there has been an increase in home working. Many of the appointed representatives (see *Managing third parties* on page 6/20), especially when they first set up, work from home. From the perspective of the firm this is often presented as a straightforward saving in office costs and more-flexible working for the employee.

However, it is not always as simple as that. Not all employees want to work at home, or at least not on a permanent/full-time basis as they prefer to separate work from home and need the social side of the workplace to function. Having large numbers of home workers also creates a new management challenge: how is performance and output managed? What is the best way to communicate to and manage 'virtual' teams? Do the easily counted savings, such as office space, really exceed the more-difficult-to-count costs such as reduced productivity and increased security of data risks?

Many firms have adopted a compromise solution. This is to base staff in lower-cost locations; for example, regional, even rural, towns as opposed to main city centres. Doing this has the benefits of lower cost of occupation and the social interaction of the office. Possible disadvantages arise from remoteness and the need for local management. Where more than one business unit has people in such a centre, there may be conflict between local and business unit needs.

Some other obvious considerations when looking at office locations include availability and cost of space, transport access and other infrastructure, such as parking, and not the least, availability of suitable staff. One of the key issues when looking at office space is the length of leases and the costs of attempting to give up space early. Many traditional leases are for periods of 25 years with no mid-term breaks.

Another feature is that traditional leases are on a 'fully repairing' basis which means that the premises must be returned to the landlord in the same condition as when first rented. In practice, a deal is often agreed whereby the tenant pays for the 'dilapidations'.

As a solution to the inflexibility of the traditional lease, serviced office premises are available in many locations. Instead of signing a traditional long lease, space is rented like a hotel for periods as short as three months. Serviced offices can include reception and other basic services. The consideration for the broker is whether the serviced office creates the right impression to clients.

Segmentation and propositions

Most brokers segment their business and propositions in various ways, for example:

- between private and commercial;
- by class of business;
- by trade sectors;
- by size of client; and
- by client proposition.

The purpose of such segmentation is to be more effective in delivering services to existing clients and in finding new clients. From the perspective of distribution, the firm needs to decide to whether and how to segment its 'propositions', where the necessary resources are placed and how are they staffed.

What are the firm's target markets and how are these to be segmented? Does the firm have the resources to serve these segments or does it need to acquire them or build from new?

As part of a trade segmented approach, what investment should the firm make in joining and supporting trade associations and other similar bodies in order to raise its profile within the selected sector?

People and skills

Who are the right people to work with clients and how should client work be managed? Can one person look after a client's needs or does the work need to be separated between relationship management, broking, technical and administrative staff? Can good client relationship people also sell more products to existing clients and also to new clients, or should dedicated sales people be employed?

Does the firm work exclusively with its own employees or does it build a network of appointed representatives – people who only provide client service, work under the firm's regulatory umbrella and pay a percentage of their earnings for support services? This may give the firm access to a wider range of clients, but at what risks in terms of control and service quality? For more on appointed representatives, please refer to [Managing third parties](#) on page 6/20.

A key people consideration is not only the cost of their employment, but also the costs if they are to be relocated or made redundant as part of a restructuring exercise. These costs are not only financial. The disruption may affect morale, stop people who were planning to leave from doing so and may dissuade new applicants.

Broker networks

Does the firm join one of the many broker networks (discussed further in [Broker networks](#) on page 2/20)?

Communication

What style and content of written communication should be adopted? Traditionally most brokers provide, as a core part of their service, a register of summary of insurances with details of all policies and claims procedures and so on. Some brokers say their clients no longer want these, especially as the speed of policy issuance has improved. Is that right and should these documents be provided as physical documents or by PDF or other electronic means?

How does the firm communicate in more general terms to its clients? This covers such items as technical bulletins, educational material, market information and other news relevant to insurance and the specific needs of the client. Techniques include traditional hard copy, email, PDFs and other electronic documents, seminars, client meetings, conferences, webinars and so on.

Global service

If the firm is serving global clients, does it build its own network of offices overseas or does it build a network of local partners?

Broking

How does the firm manage its relationship with insurers to obtain the best results for clients?

How does the firm use facilities, panels of insurers, MGAs and *delegated authorities* to consolidate placements to obtain more efficiency, improve cover and service and generate additional revenue? Can the firm explain the benefits of these arrangements to clients and avoid issues of conflict of interest?

Conclusion

These considerations have been presented as a series of questions as there is no right answer. The way brokers distribute their services may look broadly similar across brokers of the same size but there are many individual variations. Each broker adopts the distribution strategy that fits its resources and overall strategy. So far we have looked at the 'client side' of distribution. The way brokers manage their relationship with insurers is examined in the next chapter. The way brokers trade with individual clients is considered in [Different methods of trading with clients](#) on page 2/16.

E2 Broker distribution costs

For brokers, the distinction between distribution and other costs are perhaps a little less obvious than they are for insurers.

They can include:



For a broker to run a profitable business, they need to know these costs, preferably for each of the segments in which they operate, so that they can see which parts of their business are profitable, where they invest to expand and where they might wish to stop doing business or find an alternative approach.

There is no standard formula for what percentage of total costs or revenue each of these items should represent. In all firms, salaries and benefits are the largest element of costs, accounting for around 45–60% of the total. At the other end of the scale travel and entertainment might be in the range of 2–5%. The large firms also have substantial non-discretionary costs; that is, the costs that are fixed irrespective of what they do, to pay for various head office functions, from the CEO's jet to group legal. We look at the management of these costs in more detail in chapter 8.

E3 Different methods of trading with clients

The way brokers trade with clients is a function of their size, trade segments, and of course the size and resources of the broker.

E3A Personal lines

Most brokers do not compete in standard personal lines business defined as premiums less than £500. This is the territory dominated by the direct insurers and retailers' products. However, that is not to say that there are no brokers competing in this sector. They adopt different approaches as follows:

- High street shops. There is still some demand from consumers to buy their personal and small commercial insurance face to face. But, as many in the retail sector have seen, this demand has been declining fast. The key to success is efficient systems that minimise rekeying of data and that allow instantaneous issue of documents and payment by credit or debit card or other electronic means such as mobile phones.
- White label schemes where the broker acts merely as a means of introduction and then delegates all service provision to an insurer call centre.
- Central teams organised rather like call centres to obtain maximum efficiency.
In the latter two examples, although both insurer- and broker-operated call centres use technology to get maximum efficiency, generally most contact is via the phone and paper policy documents are still issued. Most of these operations avoid dealing by email although consumer pressure is driving in this direction.
- MGAs and delegated authorities to consolidate volumes of smaller premiums to generate efficiency; this allows the broker to design the product and control the end-to-end service.

For mid- and high-net worth customers, the service offering will normally be centralised and telephone-based, with individual visits only being made to clients at the very top end who are paying sufficient brokerage to justify this type of service. As the success of Direct Line demonstrated over 25 years ago, many people are willing to transact their insurance over the phone, provided the service is responsive and help is available when it is needed; for example, when a claim occurs.

The exception will be the personal insurances for the broker's commercial clients where most smaller brokers regard it as important to provide a personal service.

Another approach that is often used for specialist schemes is for the brokers to provide the front-end scheme development and new business drive, while all other servicing is handled by either a specialist contractor or the insurer.

Very high net worth clients that spend, say, more than £25,000 on their personal insurances, are likely to require a more personal service and a dedicated account executive. These customers tend to be less price sensitive, but are very exacting regarding service, particularly when a claim occurs.

E3B Commercial business

This has the same characteristics as personal lines. At the bottom, with the millions of micro businesses, premiums are low; typically less than £1,000. At the other end of the scale, the premiums for the very largest customers can run into tens of millions of pounds. It is in the micro- and small-business sector that the difference in overheads between smaller independent firms and the larger brokers becomes more apparent.

The large firms find it difficult to provide personal service for clients spending less than £5,000 in fees or brokerage. However, smaller community-based brokers are more likely to be willing to provide a traditional service to much smaller accounts.

To obtain greater economies of scale, some of the large brokers have experimented with different models. One option is to have the main client relationship contact based physically

close to the client base, with the processing and technical account handling being provided by a combination of a central office and perhaps an outsourced or offshored resource.

This can create challenges in some parts of the country where nationalistic fervour is perhaps stronger. As an example, attempting to provide service in this way to a customer in say Cardiff or Glasgow from a resource in South East England is unlikely to be successful.

Some price comparison websites are now offering SME commercial insurances, although less than 10% of commercial insurance is sold direct from insurers. Towergate was the sole provider for commercial insurance through Confused.com and Comparethemarket.com, and Simply Business support Moneysupermarket.com and Gocompare.com. However, these websites are not suitable for complex businesses or insurance products.

The Insurance Act 2015 has changed the way risk information is gathered by insurers, brokers and electronic platforms. Phil Barton, Chief Executive (insurance) at Jelf Group, believes the Act will help put the brakes on the shift to aggregator sites: 'The Act requires the insured to make a fair presentation of the risk but this is difficult if they're doing it remotely through an aggregator's site ... It's a very positive step for the insurance industry but also for these clients as they do need advice.' (Insurance Age, December 2015).

Research exercise

Research the legal case *Café de Lecq v. R A Rossborough (2012)*, in particular the broker's duty in highlighting a policy warranty on a commercial insurance policy sold through the internet. If this case had occurred after August 2016, how would the Insurance Act 2015 affect the broker's duty?



For larger accounts, most of the large and global broking firms deploy websites designed specifically to enable:

- client data to be stored electronically and securely with access to the client and its nominated staff and their counterparts at the insurance broker;
- all of the required documents such as policies, registers insurance, standard certificates, meeting minutes, outstanding items lists and so on;
- gathering of client data throughout the world;
- notification of claims; and
- self-service functions such as submission of declarations.

There is also a trend or at least a desire within some brokers and insurers towards more 'self-serve', where the customer in effect inputs data directly into insurers' systems. The internet-based models for personal and micro commercial business also try to minimise the need for conventional interaction. Although this approach works for personal and micro-commercial, there is more resistance from small- and medium-sized businesses that prefer regular interaction with their broker.

Another aspect of dealing with clients concerns the handling of claims. This will be considered in chapter 11.

E3C Invoicing

Most of us will be familiar with making purchases on the internet with payment being made in a paperless way via a credit card or secure payment service. Confirmation is normally via email that can be printed and kept if required. This is now the method of choice for personal lines and SME commercial business.

For SME business transacted conventionally, most premium payments will be processed via corporate credit cards or direct debit, especially when deferred payments are made through a premium finance company.

There is a trend for larger commercial clients to look for electronic invoicing, although 'full cycle' electronic invoicing, that is where the invoice and following statements and consequent payments are all made electronically, is still not widespread.

Paper cheques are being used less and less. Indeed most UK banks would like to do away with them completely, although this has met stiff resistance from both personal and business customers. Having said that, most larger commercial clients will pay invoices via Banks

Automated Clearing System (BACS) or one of the other electronic payment systems even if all the documentation – statement and invoices – have been issued in traditional paper form.

F Consolidation



Acquisitions tend to be cyclical and are mainly driven by principals reaching the time when they wish to retire. This time bomb is always there and, after five years of low activity, the pressure is building up. There are probably a large number of provincial brokers who would consider selling if the price was right. Management buyouts are often a preferred solution but there still seems a reluctance of younger management to take on heavy debt and responsibility and buy the company in which they work.

Source: Cornell, T. (2016) 'Another wave of consolidation?', *Insurance Age*, 3 May. Available at:

bit.ly/2i9K29y.

Consolidation is a well-known business process. It simply means a reduction in the number of businesses in a given sector through mergers and acquisition (M&A), leading to a smaller number of larger firms. The years before the arrival of the European single currency in 2002 heralded a wave of consolidation among insurers throughout Europe.

This discussion about the reasons for consolidation is a logical part of the distribution process since one of the key reasons for firms to merge is to give them more and wider access to their target markets and, in the case of brokers, to give them greater influence and leverage with insurers.

The focus of this period was the consolidation of the larger broking firms, the majors having no apparent desire to spread their net to the thousands of much smaller brokers. This was to change with the arrival of the so-called consolidators, which set out to do for small broker integration what Aon and Marsh had done earlier in the large broker sector. From around 2002, led by Towergate and joined by rivals Jelf (now owned by Marsh), Oval and Giles which have since been purchased by Arthur J. Gallagher.

Aon is the result of a veritable feast of mergers, including the 1996/7 period when it bought Bain Hogg, Minet, Nicholson, Chambers & Colls and A&A. Aon's activities triggered a response from Marsh, which bought Johnson & Higgins in 1997, Sedgwick in 1998 and HSBC Insurance Brokers in 2010. After this blizzard of M&A activity in the UK and US markets, the now very large Aon and Marsh turned their attention to building their overseas networks.

In 2011, the US broker Arthur J. Gallagher acquired Heath Lambert and, more recently, Giles and The Oval Group. Additional global acquisitions have placed Arthur J. Gallagher among the top five broking firms in the UK and worldwide, without the need for external financing.

Almost 4,000 brokers have disappeared from the market during the ten-year period to 2015, primarily due to consolidation. This has left a gap in the mid-tier market. However, a number of high-profile managers have reached the end of their covenants and are re-forming to create new entities.

Towergate disbanded its M&A team in May 2015 following troubles that rendered former private equity backer Advent's £200m equity stake worthless. Towergate is now in a new structure and is part of the Ardonagh Group.



Critical reflection

Has consolidation of insurance brokers been for the benefit of the firms themselves, their owners (i.e. shareholders in public companies) and/or their clients?

F1 The forces behind consolidation

Standard 'business school reasons' for consolidation					
Sectors considered to be ex-growth (compared with modern hi-tech business) need consolidation to make them a more attractive investment proposition.	Investment is needed to increase efficiency and profitability. This can only come through savings; normally headcount reductions flowing from integration and consolidation.	Widespread 'cosy' or weak management.	Increased buying power enables better deals to be obtained from suppliers, e.g. insurers.	Consolidation provides a firm base for expansion into new areas.	Ambitious managements see acquisitions as a faster route to growth in revenue and profits, rather than the more grinding process of organic growth.

A more cynical view would be that the key objective of consolidation is 'to take out the opposition'. Indeed, the stated benefits of many M&As have been questioned by a number of economic commentators who, with the benefit of hindsight, have assessed the proposed benefits against the actual results of the merger/acquisition, and found them wanting.

Undoubtedly, all of these drove the acquisition activity of the larger firms in the late 1990s and inspired the era of consolidation that we have experienced in the smaller broker market since 2002.

The ongoing low interest rates, stable markets and new entrants that carry capital to undertake these purchases has pushed the market to continue to be buoyant.

Factors in recent consolidations			
The availability of 'cheap' debt finance; of course this was not unique to insurance broking, but was essential to the speed of consolidation activity.	The willingness of some insurers to agree enhanced commission rates for the more aggressive consolidators.	A large supply of businesses ready to sell as principals needed to find a route to retirement.	The emergence of a group of entrepreneurial leaders in the smaller broking sector.

Although the predictions about market dominance of the consolidators have not transpired, and the cheap finance available during the early years of this century that drove the first wave of consolidation has disappeared, the forces that drove it remain. Perhaps paradoxically, consolidation has also led to new brokerages being formed, with many previous owners starting up again as the restraints imposed when they sold their firms expire.

G Working with other brokers

The circumstances where this occurs are where:

- the retail broker with the client relationship is using another broker to gain access to a specialist market such as London or a scheme that is exclusive to the scheme broker;
- a wholesaler or scheme broker is dealing with a producing broker; and
- the client decides to share its business between a number of brokers: sometimes this might be by class of business and sometimes by service, e.g. one broker designs and places a global programme and another provides the global administration or risk management services.

In the first two cases, both need to understand the needs of the other so as to obtain the best results. The retail broker wants a fast response with the minimum of information and efficient administration, good rates of brokerage, and payment terms and cover that is right for the client. The retail broker also needs to understand responsibility for the premium and the quality of the security offered.

In turn the wholesaler, in order to give the service demanded, needs strong relationships with selected markets so that terms for what often may be difficult risks can be sourced quickly. The wholesaler also needs to recognise that it is competing with a local market that may well be favoured by both the producing broker and the original client.

With respect to brokers sharing large accounts, the key issues are likely to be co-operation between firms that are otherwise competitors and a clear understanding of the different roles and dividing lines. In these circumstances, there is likely to be a service level agreement specifying the roles of each broker in detail with the relevant key performance indicators (KPIs). Typical ways in which the broker roles may be separated include:

- programme design and broking by one firm and global service provided by another;
- division by territory or class of business;
- risk management services; and
- actuarial and other analytical advice.

H Broker networks

Broadly, broker networks divide into two groups:

- Formal alliances of brokers that come together to provide mutual support – while remaining independent entities, they may mutually own a central service provider or negotiate group deals for member firms.
- Businesses formed to provide specific services and access to markets for smaller broking firms that enable them to compete more effectively.

The aims of the first group are to share best practice and to gain a commercial advantage from a mutual approach in areas such as compliance, IT development, marketing, risk management services, relationships with insurers, intranet and website development.

The firms that make up the second group offer a similar range of benefits to member brokers, but are provided on a for-profit basis. There are currently about ten broker network providers offering a wide range of services. These range from enhanced commission deals; succession planning; technical support; access to specialised resources in marine, aviation and construction; outsourced compliance; technical training and wholesale broking to the London Market.

A number of networks support very small firms (typically small teams that break away from larger firms) by treating them as appointed representatives. Some of these networks were formed only to provide services, but have now become consolidators, and some were formed with the specific purpose of buying up member brokers. The business models are diverse.

Over 1,500 brokers (around half of UK brokers) are members of networks. Joining a network allows brokers access to insurers and, through the network, obtain buying power. Some networks offer other ancillary services, such as compliance, marketing, training etc., which allows the broker to focus on growing and servicing the business.



Research exercise

Create a list of all the broker networks and visit their websites so that you understand the different models.

The issues for brokers when considering whether to join a network include the following:

- All networks charge for their services either by way of a fee or by taking a cut of the member broker's brokerage. This cut varies from around 5% to 20%. The broker has to decide whether the benefits exceed the costs, especially in relation to the deals that could be negotiated directly with insurers.
- The insurer service models offered by the networks vary. Some arrange for centralised and sometimes dedicated service from one or a limited number of locations whereas others use their existing branch network. The broker has to weigh up whether a real improvement in service will be obtained by joining the network, compared with what they can obtain independently.
- Do the additional services offered by the network, e.g. access to specialist broking services or global offices, match the likely needs of the broker?
- Some networks offer unique policy wordings that may also be loaded onto dedicated insurance broker IT platforms. These may be a valuable selling tool and may also increase efficiency.

- Most networks have preferred insurer partners that may offer exclusive products.
- Some networks mandate that members must place all or a significant proportion of their business with a select group of insurers whereas others take a more liberal approach.
- Some networks are willing to make investments in member brokers either by way of loans, debentures or minority equity stakes. These can assist expansion; releasing equity from existing to new staff and retirement and succession planning.
- The network may offer a confidential internet-based forum for the exchange of ideas and intelligence. They may also create a collegiate atmosphere among members that can provide mutual support.

I Scenario 2.1: Streamlining

I1 Question

You are a director of a long established broker with seven well established offices in large towns in one region of the UK. The firm is about to make an acquisition of another firm which bring four new offices, one of which is in a town where the acquiring firm has an office. Both firms have built their businesses partly as a result of respective strengths in agricultural businesses and the motor trade.

The private equity firm financing the deal has employed a consultant who has recommended that substantial savings can be made by closing both of the duplicated branches, closing four of the remaining offices, centralising all of the back office functions in one of the remaining offices and concentrating each of the specialties in a specific office.

Describe the issues that would need to be considered.

I2 How to approach your answer

The issues are:

- In both businesses, what is the nature of the relationship between the location of the offices and their respective clients? Is the success of the business based upon proximity of the relationship?
- What percentage of the existing business of both firms is remote from the branch structure?
- What are the current lease arrangements for each office and what would be the costs of closing down each office?
- What are the people costs in redundancy and relocation?
- Will the centralised locations be able to offer adequate service?
- Are the respective firms' IT systems capable of dealing with centralising of functions?
- Does the relocation of the specialties cause disruption to the way these work?
- Is there a similar placing strategy of business type with the same insurers where brokers can negotiate any costs savings due to the account size placed?

Self-test questions

1. What are the factors that make up distribution costs for the insurer?
2. Define a client value proposition.
3. Summarise the generally accepted reasons for consolidation.

You will find the answers at the back of the book

3

How brokers deal with insurers

Contents	Syllabus learning outcomes
Introduction	
A Fair market analysis (FMA)	1.3, 2.3
B The broking strategy	1.3
C Methods of trading with insurers	1.3
D Transacting business in the London Market	1.3
E Transacting business in the regional market	1.3
F Scenario 3.1: Broking strategy	
Self-test questions	

This chapter relates to **syllabus section 1**.

Learning objectives

On completion of this chapter and your own private research, you should be able to:

- examine the distribution models used by brokers as they apply to the broking strategy;
- explain the aspect of ICOBS relating to fair market analysis; and
- explain the process of insurer selection.

Introduction

In an ideal world, brokers should be able to deal with a wide range of secure insurers that can satisfy the insurance and risk needs of their clients at competitive terms with broad cover, paying all covered claims efficiently and promptly. In practice it is more difficult than that:

- A broad range of insurers offer a diverse range of products, coverage and service so the process of selection can be difficult.
- Even the largest brokers cannot enjoy the same relationship and influence with every insurer.
- As you will have learnt, insurers view brokers as a channel of distribution.
- Sometimes the quality of the insurer's promise to pay can only be tested when a claim occurs.
- Many insurers segment the way they deal with brokers with the effect that the broker cannot necessarily use every insurer in the same way.
- As the regulation on the process of 'fair market analysis' and selection of insurers is poorly defined, the broker needs to exercise some care in the process used for the selection of insurers, especially where additional income is generated from insurers.

In this chapter we consider:

- fair market analysis as required by regulation; and
- the selection of insurers based upon their individual characteristics.



Key terms

This chapter features explanations of the following terms and concepts:

Auto-rating	Broking strategy	Electronic data interchange	Fair market analysis
Insurer review meetings	Large risks	Market reform	Panels
Rules of engagement	Tripartite relationships		

A Fair market analysis (FMA)

The only express regulation with respect to market analysis, the number of insurers to work with and the process of insurer selection is contained in the FCA's Insurance Conduct of Business Sourcebook (ICOBS) guidance 4.1.8 and rules 4.1.6 and 5.3.3. Chapter 5 explains the difference in impact between FCA rules and guidance.

ICOBS does not apply to **'large risks'** as defined by the regulation, however, the FCA's Principles for Businesses require brokers to 'conduct their business with integrity ... with due care, skill and diligence ... take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment ... 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'.

In practice, the FCA expects all brokers to act as if ICOBS applied to all risks, not just SME. Brokers' clients come to them for expertise on the market and they expect this to include access to a suitable range of insurers. The FCA has updated ICOBS to incorporate the Insurance Distribution Directive (IDD).



Insurance Distribution Directive

The **Insurance Distribution Directive 2016/97/EC (IDD)** came into force in 2016 and each Member State, including the UK, had to transpose the Directive into their own legislation by 1 July 2018. The requirements have applied to firms since 1 October 2018. This means that although the UK has now left the EU, the IDD is still in force in the UK as it is part of UK law.

The IDD is a revision and replacement of the **Insurance Mediation Directive 2002/92/EC (IMD)**. The IDD's aim is to make it easier for firms to trade across borders, strengthen policyholder protection and provide a level playing field. It sets out consumer protection provisions in insurance and the scope of regulation is increased to include all firms that sell, advise on, or conclude insurance contracts and those who assist in administering and performing them, including those that shortlist as part of a selection process (such as aggregators), or introduce insurance. However, just providing general information about insurance products, insurers or brokers without collecting such information has been excluded, as is providing data on potential policyholders to insurers/brokers.

The key provisions of the Directive are:

- **Professionalism.** All firms engaged in any of the activities covered by the Directive must possess appropriate knowledge and ability to complete their tasks and perform their duties adequately, such as: the insurance market; applicable laws governing insurance distribution; claims handling; complaints handling; assessing customer needs and business ethics standards/conflict of interest management. Staff must complete at least 15 hours of professional training or development per year.
- **Commission disclosure.** Pre-contractual disclosure of the intermediary and the nature, not amount, of their remuneration (whether commission, fee or other type of arrangement). This would be waived for contracts involving large risks or for professional customers. The pre-contract disclosure regime will be extended to insurance undertakings. Firms must state what type of firm they are (intermediary or insurer) and whether they provide a personal recommendation. Firms that sell insurance on a non-advised basis must ensure that the products they are selling fulfil the customers most fundamental needs.
- **Harmonisation.** The IDD is a minimum harmonisation directive, allowing Member States to set stricter requirements ('gold plate') if they deem this necessary. This allows the UK to maintain its rules for retail investment advisers under the Retail Distribution Review (RDR), for example.
- **New product governance requirements**, which are largely in line with the FCA's product governance requirements.
- A new category of insurance settler called **Ancillary Insurance Intermediaries**. This includes connected travel insurance providers that don't sell or introduce insurance as their main business, but still do so and therefore are subject to selling rules.
- New duties applicable to insurance companies that are selling products through companies that are not authorised by the FCA.
- A requirement for all general insurance firms in the retail and small corporate market to provide customers with Insurance Product Information Documents. These are similar to the Key Features Documents, previously used by insurers. An IPID is a short, pre-contractual, non-personalised product summary document, the layout of which is fixed and must follow closely what is prescribed in the IDD. After 1 October 2018, an IPID must be issued to every retail customer purchasing a general insurance product, regardless of the channel being used, ahead of closing a sale or renewal. The purpose is to allow customers at the quotation stage to compare similar products offered by different insurers in an easy-to-follow consistent way so they can see at-a-glance the differences between products and make informed decisions. The requirement to provide an IPID only applies to consumer insurance contracts.

The aforementioned ICOBS rules and guidance are reproduced in full in the following.



Scope of service: insurance intermediaries Rule 4.1.6 Guidance on using panels advice on the basis of fair analysis Rule 4.1.8 Advice on the basis of fair analysis Rule 5.3.3 Personal explanation Rule 5.3.4

Where an insurance intermediary proposes or advises on a contract of insurance then in good time before the conclusion of an initial contract of insurance (other than a connected travel insurance contract) and, if necessary, on its amendment or renewal an insurance intermediary must provide the customer with at least information on whether the firm:

1. gives a personal recommendation, on the basis of a fair and personal analysis; or
2. is under a contractual obligation to conduct insurance distribution exclusively with one or more insurance undertakings, in which case it must provide the names of those insurance undertakings; or
3.
 - a. is not under a contractual obligation to conduct insurance distribution exclusively with one or more insurance undertakings; and
 - b. does not give a personal recommendation on the basis of a fair and personal analysis;

in which case it must provide its customer with the name of those insurance undertakings with which the insurance intermediary may and does conduct business.

1. One way a firm may give advice on a fair analysis basis is by using 'panels' of insurance undertakings which are sufficient to enable the firm to give advice on a fair analysis basis and are reviewed regularly.
2. A firm which provides a service based on a fair analysis of the market (or from a sector of the market) should ensure that its analysis of the market and the available contracts is kept adequately up-to-date. For example, a firm should update its selection of contracts if aware that a contract has generally become available offering an improved product feature, or a better premium, compared with its current selection. The update frequency will depend on the extent to which new contracts are made available on the market. A firm is also required to ensure that the analysis is of a sufficiently large number of contracts of insurance available on the market (see ICOBS 5.3.3R).
3. The panel selection criteria will be important in determining whether the panel is sufficient to meet the 'fair analysis' criteria. Selection should be based on product features, premiums and services offered to customers, not solely on the benefit offered to the firm.
4. Where a firm also provides personal recommendations based on a fair and personal analysis, paragraphs (1) to (3) may also be relevant to that part of the service which involves a fair analysis of the market.

If an insurance intermediary informs a customer that it gives:

1. advice on the basis of a fair analysis, it must give that advice on the basis of an analysis of a sufficiently large number of contracts of insurance available on the market to enable it to make a recommendation,
2. a personal recommendation on the basis of a fair and personal analysis, it must give that personal recommendation on the basis of an analysis of a sufficiently large number of insurance contracts available on the market to enable it to make a personal recommendation;

and in each case, it must be in accordance with professional criteria, regarding which contract of insurance would be adequate to meet the customer's needs.

Where a firm provides a personal recommendation (other than in relation to a connected travel insurance contract) the firm must, in addition to the statement of demands and needs, provide the customer with a personalised explanation of why a particular contract of insurance would best meet the customer's demands and needs.

So the decisions for brokers are:

- Do they provide advice on the basis of FMA?
- How do they demonstrate FMA?
- Do they adopt one of the other approaches in Rule 4.1.6?
- How do they communicate with their clients?

Selecting the approach

Option (a) in Rule 4.1.6 generally reflects most broker activity where a client's risks will be offered to a selection of carriers using FMA. When this regulation was first introduced, some of the very large broking firms were concerned that the FSA, and subsequently the FCA, would interpret FMA as meaning that the whole market had to be canvassed. While brokers will often seek a wide range of quotes, especially if a case is under attack, seeking quotes from every possible insurer on each case is unrealistic and uneconomic.

Consider this...

Why would it be unrealistic to seek quotes from every insurer on every case?



As a result, some of the larger broking firms decided that they could not confirm option (a) and made reference to 'limited' market or some such terminology, which in effect is a halfway house between (a) and (c). This was despite the fact that the large broking firms were more likely to implement the sort of process required to support an assertion that FMA had been implemented. The process is discussed later in the section. This was perhaps a little defensive, especially as clients approach brokers expecting them to have access to a wide range of insurers.

Experience has suggested that the FSA's approach to FMA was pragmatic. Their main concern was that customers were treated fairly and that there was clear communication. Many brokers have therefore adopted FMA for the generality of their business. The FCA's approach is yet to be seen, although to date it has not identified it as a specific issue. However, the selection of markets can potentially expose brokers to a conflict of interest, which has been the subject of an FCA thematic review. See [Conflicts of interests](#) on page 6/5, and [Transparency](#) on page 12/9, for more on FCA's review.

Option (b) is less likely to occur as brokers are not normally under a contractual obligation to place business **exclusively** with one or more insurers.

Option (c) might occur when a broker operates a single insurer facility, for example for legal expenses provided alongside a motor policy that has been selected using FMA or a personal accident and travel policy. In these cases the legal expense and PA cover are not advised sales as per option (a). However, it is likely that the broker will have gone through a tender process and used FMA to select the insurers in the first place and for commercial reasons will obviously review the facilities on a periodic basis.

On 1 April 2015 the FCA introduced new rules for selling add-ons. These rules affect any insurance products that are bundled into a policy; for example, legal expenses as an add-on to a motor policy must be clearly defined to the policyholder, and the price for the add-on should be listed separately from the main policy premium.

On the Web

You can read about the FCA's ruling on add-ons at:

www.fca.org.uk/your-fca/documents/policy-statements/policy-statement-ps15-22.



A1 What is fair market analysis?

ICOBS states that *fair market analysis* requires a **sufficiently large number of insurance contracts** available in the market to enable it to make a recommendation, **in accordance with professional criteria**. It also says that *panels* can be used to demonstrate FMA but with the circular reasoning that the panels are selected from a sufficiently large number of insurance contracts etc. There is no definition of 'sufficiently large' or 'professional criteria'. So the management challenges for the broker are:

- What is a 'sufficiently large number of insurers'?
- What are 'professional criteria'?
- How is the process of fair market analysis managed and evidenced?
- How do staff maintain knowledge of the market?

While the FSA did not define 'sufficiently large' (the definition continues under the FCA regulation), the reality is that this would have been difficult since there are so many variables at play. There are a large number of insurers competing for SME commercial combined

business, but a very small proportion of that number will write **employers' liability** for a very niche sector.

For example, with 'plain vanilla' motor fleets there are many options compared with hazardous road tanker fleets for which there are few. Defining a number would have led to argument, probably 20 or 30 sub-categories and constant revision. So the FSA was expecting brokers to exercise practical judgment and its successor, the FCA, expects the same.

It is also obvious that as a matter of commercial self-interest, the broker has to deal with enough insurers to ensure that competitive terms with the right cover are available. But the broker also has to consider the economics of approaching tens of insurers for quotes on everyday risks. Of course this is why many brokers use panels.

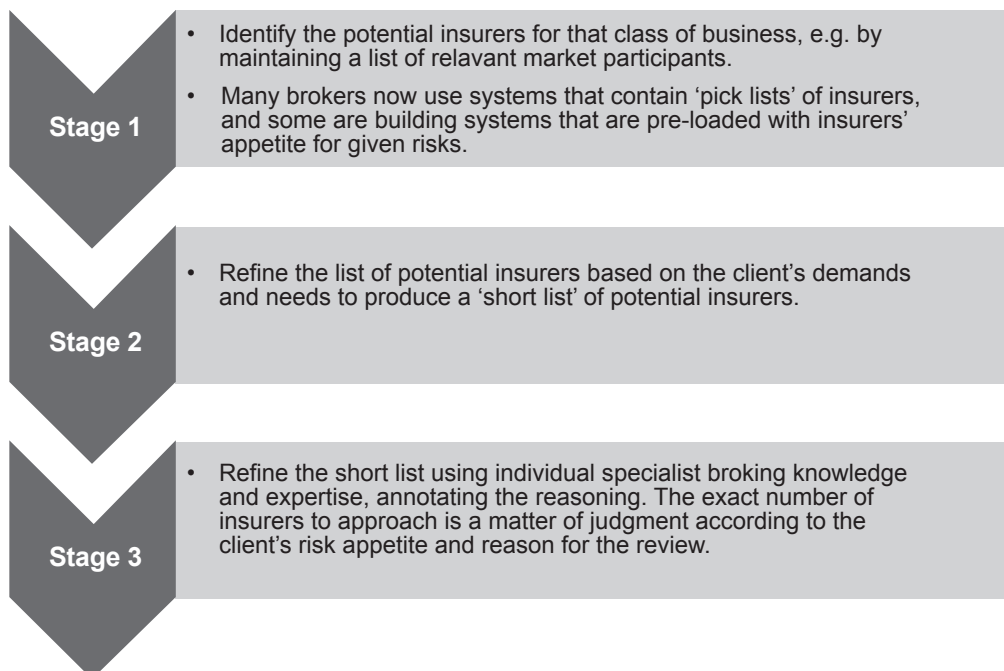


Broking management decision: Fair market analysis?

Our example of a small broker gets an opportunity to review a medium-sized law firm. There are some 15 insurers working in the solicitors' **professional indemnity** market, but the broker only has accounts and relationships with two of them. What should the broker do in these circumstances?

'Professional criteria' must be dependent on the nature and size of the risk. The criteria for placing a petrochemical plant are different from those for placing a small chain of retail shops. We look at insurer selection criteria in more detail below. Additionally, the broker has to use skill to assess the client's needs and to ensure that these are matched with the right breadth of cover and service.

In the past, this analysis would have been carried out instinctively and in the broker's head. Experienced individuals have a good working knowledge of the market and what will work and be competitive. The issue with fair market analysis is that, if called upon, the broker must be able to **evidence** this analysis. This means following and documenting a set process such as the following:



Consider this...

What other factors might affect the number of insurers asked to quote?

It is not necessary to consider every potential insurer for a given class of business. However, the broker must be able to show in writing **why** the insurers reviewed at the short list stage did or did not go forward to the final list of insurers to be approached.

Be aware

It is crucial that those insurers who are on 'the list' for a given class of business or sector are regularly reviewed to ensure that new entrants and products are properly reviewed and considered.



Broking management decision: Is one enough?

You work for a medium-sized broker and a colleague suggests that all business should be transferred to one insurer who has made a proposal with very attractive commission terms. What are the issues that need to be considered to evaluate this proposal?



A2 How many insurers?

Table 3.1 summarises nine reasons for dealing with a wide range of insurers.

Table 3.1: Nine good reasons to deal with a wide range of insurers

Fair market analysis	The broker has to be able to demonstrate that it is using enough markets to meet the ICOBS requirement.
Client expectations	Clients choose brokers for their knowledge of, and access to, the market to find the right deal. This implies an expectation that brokers have access to a range of markets. The client may not have an exact idea of how many, but they will intuitively expect this to be more than one or two. Otherwise, they may as well seek direct quotes, use the internet or, of course, another broker.
Mergers and takeovers	Consolidation among insurers is as inevitable as it is for brokers. Mergers and takeovers lead to changes in underwriting strategy and relationships.
Change in underwriting strategy	If the broker decides to concentrate its business with fewer insurers, it is obviously exposed to a sudden change in underwriting philosophy.
Unusual risks	Many insurers underwrite with an almost herd mentality, with the same lists of preferred risks. Therefore a broker needs access to markets that will tackle difficult risks, e.g. unoccupied property, woodworking or food manufacturing. In practice, for some difficult risks, it may be more efficient to deal with specialist wholesalers. Insurers may look more favourably at an unusual risk that is outside their appetite if the broker supports the insurer with a substantial amount of business.
Capacity	Larger or more hazardous risks may need multiple carriers in order to secure adequate cover.
Competitive terms	If a broker chooses to deal with only one or a limited range of insurers they are unlikely to be able to find competitive terms on a consistent basis.
Competition from other brokers	This is the real test. All brokers need a constant flow of new business. So many clients will receive approaches from other brokers offering to save money. To respond, the holding broker needs access to a wide market.
New entrants	The broker needs to be receptive to new entrants to the market. New insurers may offer competitive terms, new approaches to cover or broader cover. They might be willing to trade in a different way or offer new ways of dealing with claims.

That is one side of the coin. There are reasons to consider working with a more limited numbers of insurers:

- Many insurers will not deal with every broker and even the insurers that do offer varying levels of service.
- Even large brokers cannot maintain the same degree of relationship with every possible insurer. There are as many as 30–40 insurers competing for commercial business, but most brokers will, by normal market forces, place 90% of their account with a much lower number.
- By using a restricted panel of, say, six or seven insurers for a certain type of business, the broker can gain benefits for clients in terms of cover, service, and competitive premiums and additional remuneration. Broker-agreed wordings speed up the issue of policies by minimising the need to negotiate over cover.
- Many brokers use single-insurer facilities for business, such as travel/personal accident or excess liability, to further enhance the benefits described above.
- It can be more cost-effective to deal with fewer insurers for certain types of business. Many insurers have built products that are integrated into the broking IT systems used by many brokers. These can give additional efficiency gains.
- Concentration and aggregation of business with fewer insurers may give the broker greater influence and the ability to negotiate generally better terms overall for clients.

FMA is less relevant for price comparison websites as they tend to cover a wide range of markets. However, it is important to be transparent about those participating insurers and any commercial connections between the host and those markets.



Broking management decision: Managing arrangements

Your firm has decided to limit the use of panels and facilities to less than 20% of your revenue. How would you go about managing your arrangements with insurers to ensure that you maintain access to a wide range of insurers?

A3 Selecting insurers

In selecting insurers, the broker is obviously concerned with the relevant professional criteria as required by the regulation described above. Table 3.2 sets these out.

Table 3.2: Professional criteria for assessing insurer capabilities

Service to clients	For any business, the quality of service provided is vital. The broker needs confidence that, e.g. claims notified direct are dealt with expeditiously.
Service to the broker	The broker needs a fast response to quotation requests, prompt issue of renewal terms, claims experiences and all relevant documentation.
Underwriting appetite and specialist areas	Some carriers are only interested in 'plain vanilla' risks, whereas others are more adventurous.
Breadth of cover	This is obviously important for individual client needs, but the broker also needs an across the board flexibility, especially in the area of agreed wordings and the speed at which negotiations are conducted.
Innovation	Innovation is an overdone expression in insurance. What a broker needs is an insurer that is willing to think differently to help solve client problems. The most common example is being willing to quote non-conventionally, i.e. a self-insured programme, as opposed to conventional guaranteed cost.
Credit facilities	An obvious benefit, depending of course upon the conditions.
Capacity	Capacity needs to be adequate for the majority of clients. It is obviously driven by the scale and nature of the risk.
Geographical spread and quality of global organisation and administration	A necessary requirement for global business.
Technical advice and specialist expertise	In theory, all insurers should be able to provide technical advice in respect of their own policies. Yet in many insurers, technical specialists remain locked away, inaccessible to brokers. Thus the insurer who is willing to support the broker's technical service to clients gives a competitive advantage.

Table 3.2: Professional criteria for assessing insurer capabilities

Competitiveness	The insurer does not have to be competitive on every risk, provided it can give support when needed.
Survey and risk control	Where quotations are provided subject to survey, it is important that the insurer can carry out surveys quickly.
Reputation	Quality of reputation is a general attribute for any business. One aspect of interest to brokers and their clients is performance in relation to the Financial Ombudsman.
Financial security	The financial security of an insurer, and hence its ability to meet claims, is obviously important and should be a major factor in the broker's selection process.
Continuity	Obviously this is important at an individual client level. The broker also needs continuity when there is an individual client-based problem, e.g. an unexpected run of bad claims where the insurer takes a broad view in the context of the overall relationship.

In addition to these professional criteria, the nature of the commercial relationship is important.

Brokerage and other payments	The obvious question is to what extent a broker should allow revenue to influence selection. If one insurer offers 20% commission and another offers 22.5%, but otherwise service and cover are very similar, why shouldn't the higher rate be taken?
Access to decision makers	In many published surveys of brokers concerning insurer service, often one of the key criteria selected by brokers is access to people who know what they are doing and can make a decision. This does not mean access to the top; the broker just needs to talk to someone who understands the problem and can resolve it, and is able to do so quickly in a way that makes sense.
Relationship management and attitude of the insurer to the broker	Most insurers employ field staff to manage relationships with brokers. The broker needs to know that these individuals have the support of their management and the necessary resources to support the broker in developing business overall and with the insurer. Many large insurers have marginalised smaller brokers. This naturally causes smaller brokers to work harder with other insurers that support them and to work reluctantly with larger insurers as a 'necessary evil'.

Critical reflection

Does the rate of brokerage influence where the business goes over the longer term? Does it help the broker if the rate of brokerage is high but the insurer is uncompetitive or provides poor service?



A4 Surveys of insurer service

There are various surveys that seek to provide a quantitative and qualitative component to the selection criteria we have just described. Many of the trade magazines dedicated to the insurance market conduct their own surveys of brokers' attitudes and experience, often using professional pollsters to conduct the research. Questions are asked on all of these issues and are scored and weighted. The output is often presented as league tables for specific qualities such as technical skill, pricing, documentation and so on. Many of these magazines also run annual awards events where insurers can compete on a whole range of qualities.

Insurers also commission external organisations to contact specific brokers for feedback on their own service, compared with their competitors.

BIBA conducts its own membership surveys along similar lines to the trade press. The detailed results are available to members, although both will usually publish their results publicly. Insurers of course conduct their own surveys of broker attitudes.

Many regional brokers, as well as larger brokers like Aon, Marsh, Arthur J. Gallagher and Willis Towers Watson, now conduct their own surveys of their staff and carriers with varying degrees of sophistication and publicity. These opinion-based surveys are often supplemented with metrics on areas such as policy issue performance and speed of paying claims.

Airmic also conducts surveys of its members, looking at the behaviour and performance of both brokers and insurers. Although, as with the broker organisations, the detail of the survey will be private to members, headline information will receive broad publicity.

B The broking strategy

The diversity of the issues described above shows that there is no single answer to the question 'what is the right *broking strategy*?' Indeed a large firm might have more than one. A smaller specialist firm might focus on three or four markets, whereas the same sized broker handling a broad range of SME business will need a broader pallet. In terms of complying with Rule 4.1.6, a broker might use FMA for fleet motor, but then place all personal accident and business travel with a single insurer.

The large broking firms often talk about the need to consolidate (use fewer insurers) and aggregate (place more business into broker-designed facilities) their account with fewer carriers. Partly, this is a function of global business structures; global firms like to have global relationships. There is also the prospect of a better overall deal for clients and the broker if more business is placed with fewer carriers.

In theory at least, dealing with fewer carriers reduces administrative costs and distribution complexity for the broker. The larger consolidators of smaller brokers have also implemented quite rapid consolidation of business with fewer carriers.

To obtain broader access to other insurers, smaller brokers might also consider some other options:

- Join one of the networks described in [Broker networks](#) on page 2/20. Often these networks offer higher commission deals for their core or strategic carriers. Some networks mandate where business must be placed whereas others give the broker the option of negotiating their own deals with the 'strategic partners' and also dealing with other carriers. In essence, networks give smaller brokers access to a wider range of insurers on better terms than they could achieve independently.
- Seek out MGAs that cater for the needs of the smaller broker.
- Form a purchasing group with other similar-sized brokers.
- Targeting one or two insurers where the broker is suffering from poor service by getting to the right relationship management people and demonstrating the value of the broker's account and why it is a growing business that insurers should be dealing with.
- Use one or more of the many specialist wholesalers.

Tables 3.3 and 3.4 consider some broking strategies for larger and smaller firms, respectively.

Table 3.3: Broking strategies for larger firms

Sector	Market	Notes	Comments
Micro SME	Maximum <i>auto-rating</i>	MGA but with focus on preferred lines of business Small panel of insurers that have been pre-qualified in terms of cover and service	Avoid business that is 'non-standard' or direct to another facility
Small	MGA/Panel	Benefits and disadvantages of the MGA model versus the panel	How is business selected for the panel as opposed to the MGA?
Medium	Facilities and panel	Needs portfolio underwriting	
Upper medium	Open market but defined criteria such as agreed wording	Broker needs to invest time and effort into getting the wording and process right	
Large and global	Open market but with wording and service criteria		
Travel/personal accident	Broker facility	All business up to a premium limit	Need to consider adverse client reaction
Excess liability	Preferred online facilities	Insurer technology used	

Table 3.4: Broking strategies for smaller general firms

Sector	Market	Notes	Comments
Micro SME	Single insurer internet facility with auto policy issue and billing	Review every three years	No active marketing
Small	Four major insurers and four specialists with one motor focused		Can this type of panel accommodate a broad range of trades?
Private motor	Two insurer facilities, one of which writes other personal business		Risk in limited markets
High net worth personal	Limited binder	Review every five years	Service based with no aim to be cheapest
Medium	Open market with focus on insurers used for small business but with another four to five to provide broader reach		

Table 3.5: Directors and officers liability division of a large broker

Sector	Market	Notes	Comments
Small	Online access to two insurer facilities with broker agreed wordings, auto binding and invoicing	Review insurers every three years for scope of cover and efficiency of system	Price proximation but not cheapest
Medium	Four insurer competitive facilities	Agreed wording and three year review	Additional income for work transfer
Large	Open market	Agreed wording for primary and excess covers	

Note the example provided above (directors and officers liability division of a large broker) provides an example of the type of business division that would operate in a large broker. Other examples of divisions may be professional risks, aviation and marine.

B1 Information to support a broking strategy

In developing its broking strategy, the broker must think about the information it needs to support it.

Table 3.6: A 'wish list' of information to support a broking strategy

A good database of current clients is essential. Valuable information includes:	Identification number or VAT registration number where the firm is big enough.
	SIC codes: these are standard international codes for the trade or occupation.
	Key exposure variables such as payroll, turnover, full time equivalent headcount and total sum insured.
	Summary claims data for at least three years, or longer if the risk has long-tail exposure.
A good understanding of insurer performance in relation to regular broking activity.	How many submissions were made to insurer X? How many did they quote? How many did they reject and how many did they bind? Even better if reasons for acceptance and declinature can be identified.
An understanding of the broker's account profitability with given insurers. This is relevant for two reasons:	This knowledge is helpful in discussions with the insurer if the broker is still taking contingent commissions that are partly based on account profitability.
	Even though a broker has limited control over the losses of its clients, insurers do look at the profitability of different broker accounts and will take specific action to 'correct' what they consider to be poorly performing business. The irony is that it is likely that the insurer's original decision on price led to the 'poor' performance in the first place.
And a note on collecting account profitability information...	Some insurers are willing to provide account profitability information, some cannot because of systems issues and some just will not. The broker has to weigh up the value of this information against the cost of collecting it.

Why is all this necessary for a broking strategy? Access to this kind of information will assist the broker in discussions with new insurers who will be interested in the 'book'. It is also essential for discussions with existing insurers regarding their performance. The majority of brokers are small in relation to the insurers they deal with and so they need the best negotiating tools they can find.

The data will also indicate whether there is potential to create a worthwhile facility for a segment of business. Insurance, if it is about anything, is about data. When building facilities, the way to gain sustainable competitive advantage is to demonstrate to an insurer that there is a good source of profitable business. This can be done with limited information, but for the best results, detail is essential.

All insurers monitor their performance by keeping records of the number of risks submitted, risks declined, risks quoted but not taken up, and the number of risks bound. Brokers are also taking it upon themselves to implement their own management information to track the profitability of business and books of business. This allows them to be one step ahead of insurers when negotiating deals.

What is missing from this analysis is why they win some business and not others. As a result, the large brokers are building systems that capture this data with the intention of selling it to insurers in return for payment, normally in the form of an additional brokerage.



Critical reflection

Is this aggregated data the property of the broker, even though it is derived from individual clients? Does it create any issues of conflict or disclosure?

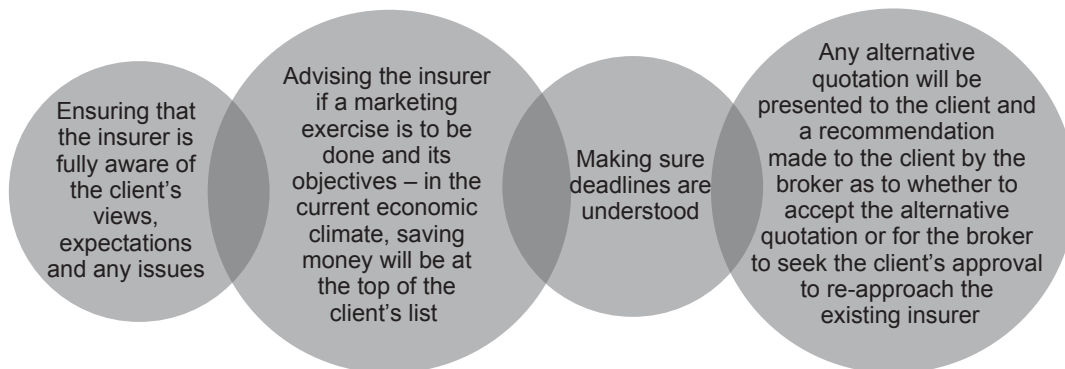
B2 Rules of engagement

In the case of the holding insurer providing renewal terms, but an alternative insurer offering improved cover or terms, the broker has a responsibility to provide a recommendation to the client. However ultimately the decision will sit with the client. The question is: how much advantage is to be given to the incumbent insurer and how fair is this on other players in the competition? Brokers also have to keep a wary eye on the **Competition Act 1998**. See [Competition law](#) on page 6/31, for more detail on the Competition Act 1998.

In a dynamic market, all such decisions have consequences. A competing insurer that feels that it has made an effective and competitive proposal may be aggrieved if their terms are 'fed back' to the holding insurer. As a result, they may decide to make a further attempt to secure the business at a subsequent renewal by offering better terms to another broker who agrees not to reveal them to the holding insurer.

In these circumstances, the broker needs to be absolutely confident in the client relationship, so that any issues, real or apparent, are in the open. The client's relationship with the insurer must also be considered. Obvious points are whether recent claims have been settled satisfactorily, whether there are additional premiums due and other service issues.

So, bearing all this in mind, the '*rules of engagement*' might comprise:



B3 Insurer review meetings

Regular meetings with insurers help build and maintain relationships with them and might form part of the broking strategy. The subjects for discussion could include:

- future renewals, both those held by the insurer and those that they may be interested in quoting for;
- cases where a market exercise is likely to take place with an outline of the client's requirements;
- past cases submitted and won, quoted and not bound, and no-quotes;
- new business that the broker is prospecting, is confident of winning or has won;
- service issues;
- making sure the broker is up to date with developments in the insurer that may affect its competitive stance, appetite for certain risks, underwriter authority levels and changes in policy forms;
- advance notice of an intention to increase rates; and/or
- the working relationship with the claims function to help with reviews of claims experience and give early warning of problems with claims, particularly if there is a serious issue, e.g. possible declinature.

Maintaining good relationships in this way is beneficial to the broker as:

- a good relationship helps ensure the broker's risks are dealt with first;
- it may assist with negotiations on difficult claims;
- many insurers may be willing to work with and even fund (subject of course to necessary disclosure) brokers for marketing projects and campaigns;
- insurers can be a useful source of general market-based information; and
- insurers also conduct detailed sector-based research that they will be willing to share with supporting brokers.

B4 Tripartite relationships

Traditionally, brokers would try to keep insurers at a distance from the insured. Occasionally, in the SME sector this is reflected in disputes over who owns the client, especially when insurers cancel agencies (for good or bad reasons) and attempt to transfer the clients to another broker or deal with them direct. Admittedly, this only happens in the SME sector.

The larger brokers certainly recognise that the client having a good relationship with insurers is just as important as the client having a good relationship with the broker, or the broker having a good relationship with the insurer. On large corporate risks it helps to provide a good long-term risk management strategy, and even solidifies client loyalty. Also, insurers should always be aware that the broker's paramount duty is to the insured and not the insurer.

The broker's response must be to:

- focus on the client relationship; the broker is being retained for independent advice and consultation and most clients value this, otherwise they would not use brokers in the first place;
- invest in the technical skills and knowledge that clients find reinforces their decision to appoint a broker; and
- have confidence in their skills so that they work with the insurer and the client in a tripartite way, where each party contributes fully.

Brokers that provide the best skills and advice can have confidence that their client will value these assets.

The **Insurance Act 2015** places brokers and clients under a duty to make a 'fair presentation' of the risk to underwriters. By introducing underwriters directly to clients, this will help them gain a better understanding of the business operations and risks.

C Methods of trading with insurers

Brokers can trade with insurers in a number of ways; table 3.7 lists some.

Table 3.7: How brokers trade with insurers

Direct communication	Conventional post and fax: now almost completely replaced by email, but still preferred by the legal fraternity for certain documents and some foreign territories for evidence of cover.
	Face to face: the preferred route in London, but supported by email and other methods. The majority of negotiations in London are conducted in this way.
	The phone: still key, particularly for smaller firms and often the source of complaints in surveys of insurer service, especially when dealing with call centres.
	Email: now the dominant form of communication with the obvious advantages of cost, simplicity, availability and speed; there are some concerns about security, but these are being removed as improved encryption software becomes widely available. Many insurers now routinely issue policies as PDFs by email.

Table 3.7: How brokers trade with insurers

Electronic systems	Broker websites: these have been developed by the larger firms to manage client service and exchange underwriting data with the client; increasingly being used to distribute data to insurers as they are secure and can handle large volumes of data and the broker can see who has visited the site and when.
	Insurer websites: outside the personal lines segment, these are still mainly used as information portals as opposed to trading platforms; however, some insurers have developed effective systems for simpler products that can produce instant quotes, bind cover and issue documentation.
	Insurer proprietary systems: for instant underwriting, document issue and premium payment.
	Direct entry to insurer systems: for dedicated facilities schemes some insurers allow brokers to enter data direct into their underwriting systems; this is a benefit for the insurer and they may reward this work transfer; the broker, however, still has to input data into their own system.
	Polaris imarket: owned and controlled by the UK insurance industry with the focus on improving the efficiency and reducing the costs of transacting business involving insurers and intermediaries by facilitating the introduction of an electronic marketplace in insurance products. To date, the main impact has been in the personal lines and SME commercial sectors. Polaris has three main aims: 1. To provide the security and infrastructure to enable comparative trading that is available to all insurers and brokers. 2. To set data standards (question sets known as schemas). 3. To develop rating technologies – known as the Product writer RTE – that enable insurers to write the rules for insurance products easily by maintaining flexibility. The data standards aspect of the Polaris business are increasingly becoming the most important as it is creating a trading environment that ensures each question means the same thing to each insurer. This is to avoid the allegations of mis-selling which circulate the aggregator market and might stop brokers wanting to use an electronic platform.
	Proprietary systems: insurance products residing on proprietary software systems such as Acturis, Open GI, SSP and Insure.com, which enable direct transmission of data to insurers' systems.
	Broker proprietary trading systems: developed by major brokers and insurers to facilitate the trading of insurance and reinsurance contracts, particularly facultative reinsurance.
Industry facilities	MGAs: brokers can trade with insurers through MGAs by setting up their own facility or by placing business with an MGA instead of going to the insurer direct.
	Lloyd's Exchange: this allows market participants to transfer risk information to each other using electronic messaging standards, thus removing the need to maintain multiple connections with other parties and suppliers in the market and ensuring that one standard is enforced.
	Association for Cooperative Operations Research and Development (ACORD): a global, US-based, non-profit, standards development organisation, serving the insurance industry and related financial services industries. ACORD's mission is to facilitate the development of open consensus data standards and standard forms. ACORD members include hundreds of insurance and reinsurance companies, agents and brokers, software providers, and industry associations worldwide. ACORD works with these organisations towards improved data communication across diverse platforms through the implementation of standards. ACORD maintains offices in New York and London.
	Brokers trading with brokers: access to insurers may only be available through specialist schemes. An insurer will provide delegated authority to one broker in relation to a particular segment of business related to the brokers' specialist area. The insurer will not quote in the open market, but only offer cover through their designated broker.

C1 Advantages

These methods have their benefits and disadvantages. The almost complete adoption of electronic and internet-based systems is the obvious result of advantages perceived by all:

- **Improved efficiency** through the elimination of paper, processes and 'double keying', whereby data is entered into one system, transmitted conventionally often by paper and then rekeyed, increasing costs and the chance of errors.
- **Responds to client demand** for online and **electronic trading**, such as the elimination of paper invoices and instant policy issue.
- **Meets environmental concerns** by, e.g. reducing the use of paper.
- **Facilitates the outsourcing** and offshoring of tasks and processes.
- **Improves management information.**
- **Image systems** remove the need for paper files and enable paperless offices.
- **Provides access** to clients and markets worldwide.
- **Facilitates 'self-serve'** by clients to reduce costs and errors in the process.

C2 Disadvantages

Refer to

Refer to: M81, section 1D2, and IF1, section 10A, for detailed coverage of the Data Protection Act 1998. You can find these on RevisionMate.

The disadvantages of electronic trading might now best be described as 'challenges'. This is because the use of electronic trading in its various guises is ubiquitous and inevitable. Table 3.8 lists some of these challenges.

Table 3.8: The challenges of electronic trading for the broker

Cost	Maximum efficiency requires all parties in the process to work to similar standards and protocols; this has been one of the main challenges and costs in the insurance market in London and the wider UK. Electronic trading works best when it permeates the whole business process. In the insurance context this means integrating the data into all functions and systems such as accounts, marketing, sales, underwriting and claims. This requires considerable investment, not only in IT, but also in the structure and processes within the business.
	The cost of investment in systems, particularly websites, to make them more responsive and effective. Modern websites are very expensive to maintain. As an example, the BBC has a site containing millions of pages and spends more than £200m per year in development and maintenance.
Email	The use of email has exploded in a somewhat unstructured fashion, which has led to concerns over the security of messages and the fact that data, often private if not sensitive, can be transmitted anywhere in the world instantly.
	Emails relating to insurance transactions and other important exchanges with the clients and insurers need to be filed in a structured way using common folders with multiple access; until systems are devised that can cope with this automatically, there is tremendous reliance on people filing them in the right place.
	Procedures need to be built to deal with emails sent to people who are absent for whatever reason; this requires mandatory 'out of office' protocols.
	People have rapidly become accustomed to use email in ways that would not have happened in the days of traditional letters, phone calls and face-to-face contact; emails can be abusive or just rude.
Security	Emails never disappear and will frequently form a large part of modern legal action.
	General security threats caused by viruses and hackers, organised crime and other malicious people gaining access to systems to steal or corrupt information or close systems down; while these risks are real, commercial reality is that the economies in all forms of electronic trading outweigh them.
Legal and regulatory	The 'internet is free' mentality, typified by illegal downloading of music and video.
	There is legal uncertainty over electronic documents, although as with the threat of cyber risks, the benefits outweigh this issue.
	Regulatory conflict between the worldwide nature of the internet and local laws.

Table 3.8: The challenges of electronic trading for the broker

Lag	The insurance market moving faster to adopt electronic data interchange (EDI) – the electronic transmission of data in specified formats to enable direct data entry into systems) than its commercial customers.
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Notwithstanding these problems, the continued development of electronic trading is inevitable as all businesses, not just insurers and brokers, seek greater efficiency. Some speculation for the future might include:

- systems that can integrate the millions of emails into client records automatically;
- completely paperless offices; and
- all transmission of data between brokers and insurers streamlined to eliminate re-keying.

Critical reflection

Can you envisage other ways in which electronic trading can improve the service that brokers give their clients and insurers?

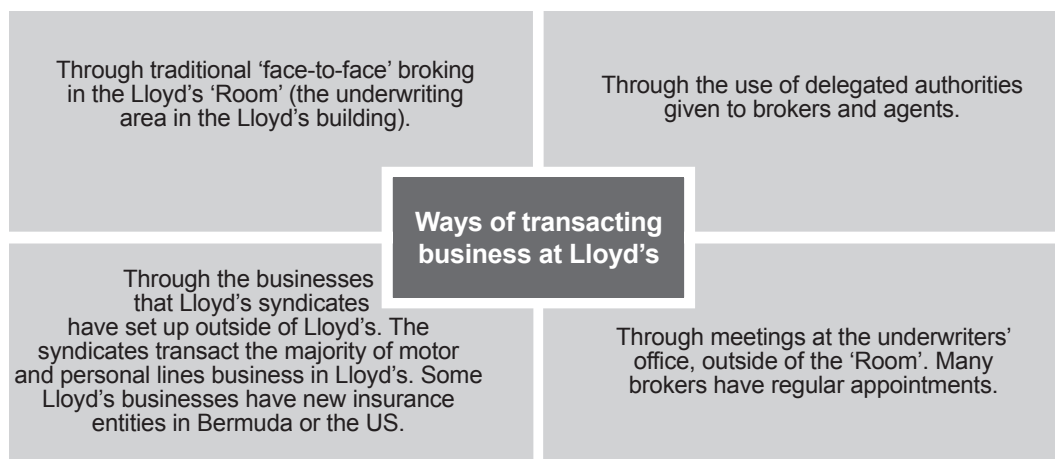


Broking management decision: Trading methods

Evaluate how brokers might make the best of all the available trading methods, taking into account cost, benefits and advantages for clients.



D Transacting business in the London Market



In addition to the Lloyd's syndicates, many other so-called company underwriters have 'boxes' in the Lloyd's building on the upper trading floors, or offices in the London Underwriting Centre at Minster Court a short distance from Lloyd's, or in the vicinity of Lloyd's. Most company underwriters are members of the **International Underwriting Association (IUA)**. Most business placed in Lloyd's or with IUA members is processed through Xchanging.

As well as Lloyd's and the IUA there is the '**open market**'. This simply means that risks are processed individually insurer to broker, as they are outside of London. Most UK business for major corporate clients and global programmes placed in London are normally placed in the open market. Some other aspects of this market are:

Slips – Most individual risks are placed on 'slips'. A slip is a written summary of the risk, laid out in a standardised way, with clauses specific to the way business is done in London. This is often supported by supplementary information, such as the broker's underwriting submission. The slip sets out the broker's relevant reference numbers, type of insurance, sum insured, period, location, clauses and conditions as applicable, and most of those other essential details found in an insurance policy. Underwriters' lines are recorded by 'stamps' with the line size and reference. There is much going into electronic trading to replace these hard copy documents with electronic versions.

Leading underwriters – Certain underwriters specialise in particular classes and risks and become market leaders. The leader sets the terms by offering the best combination of

knowledge, capacity and credibility to attract the support of other underwriters. Subsequent underwriters on the slip are bound by these terms. The broker's skill lies in selecting the best 'lead' for a given risk.

The law and Lloyd's – For the proportion of a risk placed 100% in Lloyd's, the law is that a contract of insurance – binding on the underwriters to cover the risk in question – is made when an underwriter initials the slip presented by a Lloyd's broker. When that slip is completed for 100% or any other required proportion of the risk, with no amendment of the terms, cover is complete since those initialling have bound themselves to issue a policy under the terms described by that slip.

Market reform – The way business was conducted in the London Market has been the subject of substantial reform since 2005. New placing standards were introduced – initially called London Market Principles slip (LMP slip), now known as the Market Reform Contract (MRC) – to provide a standard format allowing brokers to present contracts in a consistent form. This was partly in response to the need to achieve contract certainty but was also to improve the efficiency of the market so that it could compete more effectively.

Role of the broker – In the London Market, the drafting of policies has long been the responsibility of the broker. This requires them to maintain skilled staff to prepare and submit policies to Xchanging for the policies to be checked and signed on behalf of the underwriters. Brokers are also responsible for appointing loss adjusters and negotiating and collecting claims from subscribing underwriters.

Xchanging – This is a public company that specialises in outsourced office processes. It assumed the roles of the Lloyd's Policy Signing Office (LPSO) and the company market equivalent, the Policy Signing and Accounting Centre (PSAC), which had been responsible for receiving and checking policies from Lloyd's brokers and distributing premiums to underwriters. It processes premiums and issues policies on behalf of subscribing underwriters.

E Transacting business in the regional market

Brokers that are not actively placing business in the London Market will generally use their regional insurance office. However, because of the many M&As that have happened (for both brokers and insurers), the insurer and broker may be geographically quite distant from each other. The principles of trading remain the same; the broker may visit the insurer's premises or, more likely, the insurer will visit the broker. Due to the proximity of trading most of the trading will be undertaken either electronically or by the telephone.

Note that international programmes for insurance business may also operate from a non-London broker and in this instance the principles of trading will follow the regional market pattern.

F Scenario 3.1: Broking strategy

F1 Question

You have recently been appointed to head the division of a national broker that looks after SME business. Currently, the division places about 60% of its business with a panel of five insurers, with the rest placed with about 20 insurers. You are aware that the margin produced by the division is less than the average for the business as a whole. It has been suggested that the margin could be improved by adopting a different broking strategy and forming an MGA, placing the business with less insurers or a mixture of both.

Outline the issues and information requirements that need to be considered before such decisions can be made.

F2 How to approach your answer

Key points of content

You should aim to include the following key points of content:

Issues to deal with

- Why is only 60% of the business being placed with the incumbent panel? Are they the wrong insurers, do they offer insufficient flexibility or appetite?
- What is the overall business mix of the client base? Are there any specific needs that have to be met, such as for specialist trades or current schemes?
- How much of the book would be susceptible to placing with the MGA?
- If a profitable slice of the book can be carved out, what would be the impact on the rest of the book for clients and current insurers?
- How would staff and clients react to such a strategy?
- Should the MGA be offered to current insurers or a new panel? How would the current insurers react to the possible loss of business?
- Could a solution be found by retendering the current panel?
- Does the client mix need to be adjusted?
- Is the division going for the right type of new business?

Information required

- A full schedule of all clients with current premiums and rates of brokerage and any overrides received.
- Claims details per client and in overall terms for say, the top six to ten insurers.

Self-test questions

1. Give the definition of fair market analysis.
2. Summarise the reasons for dealing with a smaller number of insurers.
3. What are the methods that a smaller broker can use to gain access to markets?
4. What are the benefits of insurer review meetings?
5. Summarise the challenges to electronic trading.

You will find the answers at the back of the book

4

New business development

Contents	Syllabus learning outcomes
Introduction	
A Components of the sales process	1.3
B Dedicated sales staff v. client servicing staff	1.3
C Incentivisation	1.3
D Building a sales culture	1.3
E Volume sales	1.3
Conclusion	
F Scenario 4.1: A sales plan	
Self-test questions	

This chapter relates to **syllabus section 1**, relating to the new business process.

Learning objectives

On completion of this chapter and your own private research, you should be able to:

- examine the new business process as it relates to insurance brokers; and
- examine the importance of internal controls as they apply to the new business process.

Introduction

All businesses, regardless of industry, need to make their products or services available to those that may have a demand or need for them. Without making sales, businesses will have no income to pay for their outgoings and will not succeed. Insurance brokers and insurers are no exception to this; both need to attract and retain clients in order for them to remain in business. An insurance broker's new business development strategy is a process of generating sales by attracting new clients and offering them services.

Success in sales requires:

- an effective strategy;
- consistent execution and persistence;
- realistic matching of the skills and resources of your business to the needs of the prospect;
- regular monitoring of the processes;
- balancing the mix of dedicated salespeople and client service staff;
- the right incentivisation of staff;
- allowing staff to focus on their key objectives;
- senior management support and engagement; and
- the creation of a **sales culture**.

The **sales process** will vary according to:

- the type of insurance products, e.g. personal lines. This tends to be more price-driven, compared with large commercial business that can involve complex risks and/or global spread, and may take years of individual relationship 'courting';
- whether it is an annually renewable policy or 'one-off' service such as travel insurance or risk management;
- the target market, e.g. affinity group, or those purchasing product-related insurance such as mobile phone insurance or product warranty; and
- the method of sale, e.g. phone, internet, retail outlet, outsourced call centre or development by the firm's own sales team or experienced/technical account managers.

We describe the components of the sales process below. Exceptional growth can only be achieved by a combination of the right culture – one that is focused on sales and retention, a consistent process that is monitored and executed effectively, the right selection and motivation of staff, and clear leadership from the top.



Key terms

This chapter features explanations of the following terms and concepts:

Incentivisation	New business target	Outcome analysis	Pipeline
Prospect generation	Sales culture		



Broking management decision: The sales culture

How would you develop a sales culture so that your firm can outperform your competition?

A Components of the sales process

There can be an aura of mystery and intimidation about successful sales-led businesses. What they are not are the high pressure sales organisations stereotypically exemplified by the sale of certain home improvement products. They are well organised, disciplined and deploy quite simple techniques to achieve exceptional results. The components include the following categories:

A1 The new business target

The first step in this process is to decide upon the new business target. There are two views:

- It is the revenue the business desires **less** the business it expects to renew.
- It is the amount determined by the difference between the **expected** retention ratio and the **known** revenue **plus** the realistic growth in the business.

In practice these are both the same, the first is just expressed a little more cynically. Most brokers will aim for a retention ratio of at least 90% and an ideal of 95%. It is virtually impossible to get to 100% since some clients will disappear as a result of 'births, marriages and deaths'; that is, there will be new businesses formed, some will be taken over, and some will die. Let's stick with 95%.

If the firm has revenue of say £5m of brokerage and fees and a 95% retention ratio, it must win £250,000 of new business, plus a bit to allow for inflation, just to stand still. If it wants to grow by say 5%, then it will need new business of around £600,000 or 12% of revenue. Don't forget, this calculation just takes into account 95% retention. In addition the business will face all kinds of 'headwinds' that range from increased employment taxes to reduced income as a result of a softening market. Without growth, the business will inevitably go backwards.

A2 The sales pipeline

There is an 'iron law' in new business; if you don't have an active *pipeline* of prospects then you will not win any or sufficient new business. The concept is simple. Take a new business target of £600,000. A profession standard 'hit rate', that is, the ratio of cases won to cases reported on, is around 33%. Some firms aim much higher. 33% means that, in our example, the firm needs to report on prospective clients with an aggregate value of £1.8m. Remember, these are active reviews, those cases where the client has decided to conduct a competitive exercise.

In turn, these cases will be drawn from a bank of prospects which will be in varying stages of relationship with the broker. These will vary from 'stone cold' (or 'suspects' as they are known colloquially), little more than a name and address, to relatively warm. So to yield our active reporting base of £1.8m, we will need many times that number – probably at least three times again – and so the gross value becomes £5.4m or in excess of the current revenue. Of course, these figures can be changed. The hit ratio might be 45% or 50% and the conversion from the pipeline say 2.5 times. But that still means that to achieve the target, the gross value of the pipeline must be at least four times the desired new business number.

This approach is admittedly simple. In reality, it would have to be aligned with the firm's strategy for growth. Many firms have much more ambitious plans to grow at say 10% or more. But these are more likely to include acquisitions or substantial investment. It does not take into account the possibility of developing new business from existing clients. Normally, that would be managed separately from pure 'new new' business.

A3 Managing the pipeline

A variety of techniques are used to manage the pipeline. These include the following:

- **Systems** – the pipeline data can be held on a spreadsheet but it is now more common to use specifically designed databases. These can vary from software which runs on a laptop through to networked global sales management tools; the ideal is to integrate the pipeline with a customer relationship management (CRM) system; the approach chosen will be a function of size, the number of people requiring access, geographic scope and what can be afforded.
- **Status** – all purpose-designed systems include a ranking system that categorises each prospect by the closeness of the relationship, ranging from no contact having been made through to regular and friendly dialogue; some firms use as many as seven categories, however, four, 'cold, warm, hot and reporting' work for most.
- **Alignment with broker skills** – each prospect should be assessed against the skills and resources of the broker to ensure that the broker has a good 'fit', thereby increasing the chances of success.
- **Sectors** – prospects should be classified by their trade segments – this facilitates campaigns described below.

- **Reporting weighting** – once a prospect has moved to the stage where the firm has been invited to review, it is appropriate to weight the chances of success; this might vary from 33% or whatever the normal hit rate for the firm is, to a much higher percentage if there are clear 'buying signs' from the prospect. Typical signs are: positive feedback, regular discussions, requests for information not connected with the review, and so on. The weighting then feeds into the pipeline total so that the firm has a clear picture of progress towards the ultimate target.
- **Outcome analysis** – so as to improve future performance, it is good practice to analyse why accounts are won and not won.

The pipeline system also yields important management data that will form part of the suite of operational and financial controls examined in chapter 8. These include performance by:

- the overall business, individual divisions and branches;
- individual and team performance; and
- segment and speciality.

The data can inform investment decisions in new people, locations and sectors and also provides senior management with a leading indicator to assist with strategy and planning.

A4 Prospect generation

Pipeline development only works if there are prospects to put in it. Table 4.1 lists the methods by which prospects can be generated.

Table 4.1: Methods of generating prospects

Networking	Attend conferences and seminars organised within and outside the risk and insurance sector to keep up to date with topics important to clients.
	Organise events on topics of interest for clients and prospects.
	Social and business networking with the local business communities to make contacts, e.g. local Chamber of Commerce and charity events.
	Targeted hospitality based upon research to identify tastes.
Relationship building	Introducers who are generally 'well-connected' individuals who provide introductions to prospective clients. The use of introducers is being more closely scrutinised by the FCA, with a greater focus on overseas business.
	Referrals from satisfied clients are an excellent source of introductions.
	Reciprocal arrangements can be affected with other professional service providers, e.g. lawyers and accountants.
	Maintain relationships with existing contacts who change jobs.
	Build on relationships with the directors of existing clients and their roles on other firms' boards. Cross-directorships must be handled with care, however.
Marketing	Run campaigns (a coordinated series of actions) aimed at a target prospect group.
	Mail shots and cold calling are frequently used techniques. Challenges in their use involve IT systems blocking unsolicited mail and the maintenance of up-to-date contact lists.
	Advertisements can be expensive and unsuitable for the message a broker wishes to get across. Sponsorship tends to be focused on local events rather than major national events, e.g. sport falls outside of the budget for most brokers. Of course there are well known exceptions, such as one global broker's sponsorship of a premier league football team.
	Use specialist contractors to conduct detailed research in prospective clients' attitudes to risk and insurance.

A5 Cold calling

Cold calling can be unpopular with client services but if there is no pre-existing relationship, the only way to create new business is to pick up the phone. With some prospects this might be a long and frustrating process. There is an art to successful cold calling, the full detail of which is outside the scope of this course.

However, success often requires a combination of research using public data such as websites, having a 'hook' or story to tell that will get the prospect's interest, and the right personality that can deal with the frequent rude responses. It may be combined as part of a 'campaign' involving mailshot, seminars and hospitality. Calls are usually made by phone, as simply 'knocking on doors' is impractical as a means of selling commercial insurances.

A decision maker will be much more likely to accept a phone call rather than an unexpected visit. Persistence will often bring rewards. Prospects that are 'impenetrable' may change suddenly for all kinds of reasons. This will only be discovered through regular contact.

There are a number of general rules and regulations around cold calling and marketing calls:

- Before commencing any marketing calls, companies need to make sure that the telephone number is not listed on the Telephone Preference Service (TPS) or the Corporate Telephone Preference Service (CTPS). Individuals can opt out of receiving marketing calls by registering with the TPS and Companies can opt out by registering with the CTPS.
- In cases where a customer is not listed on either TPS or CTPS, but requests not to be contacted by the company directly, the company should keep a 'do not call' list, also known as a suppression list. Any new data or call lists should be checked against the TPS, CTPS and their own internal 'do not call'/suppression list. Existing data needs to be screened against the TPS, CTPS and the 'do not call' list every 28 days.

Many brokers invest in automated diallers or automated calling systems (ACS) where the rules become stricter.

On the Web

www.tpsonline.org.uk/tps/index.html.

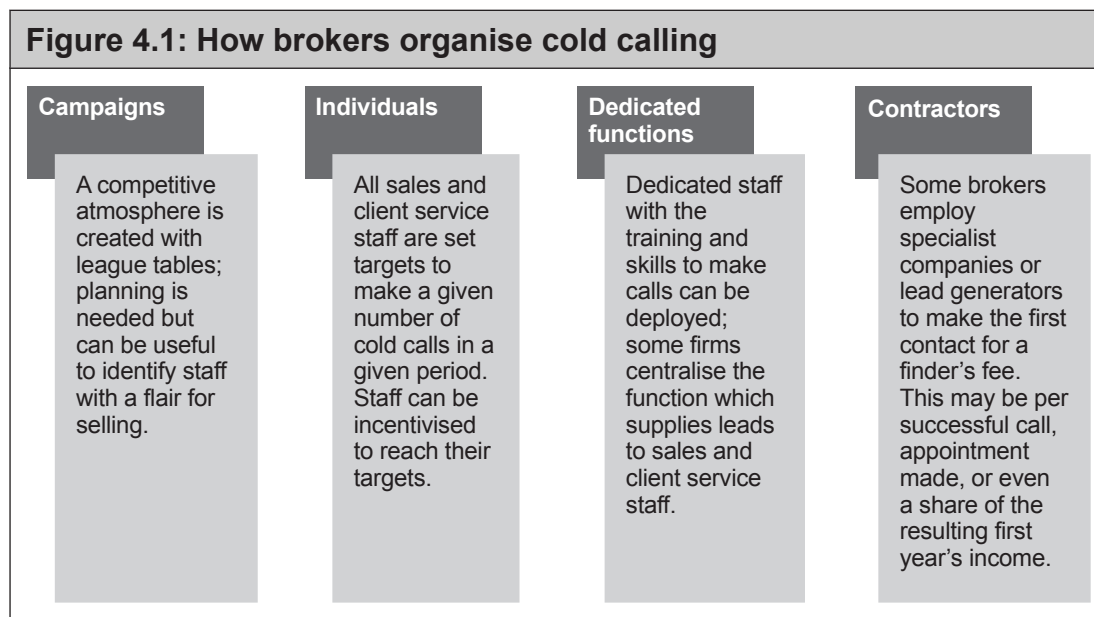
bit.ly/2zhYaTG.

bit.ly/2OUSCTS.



Cold calling has an important function as a basic fact-checking tool. While making appointments or getting through to decision makers is the difficult part, it is often much easier to glean basic but important data such as the names of key staff, their locations, email addresses and renewal dates. Practice varies as to how cold calling is organised by brokers.

Figure 4.1 sets out some options.



Broking management decision: Organising cold calling

How would you decide whether to decentralise cold calling, build a central resource or outsource to a specialist contractor?



Successful sales organisations use a combination of all these techniques, from seminars through to cold calling, with the objective of building up a 'pipeline' of contacts which can be developed into a list of 'warm' prospects. A warm prospect is one where some form of relationship has been established, an identification of needs and wants has been made, and the prospect is sufficiently familiar with your firm to be ready to do business.

Once this stage has been reached, the function of selling or converting prospects into sales takes over.

A6 Managing the first meeting

At an individual level the planning for the first meeting is tailored to the specific needs and size of the prospect. However, the firm should set a style that is applied consistently that will include:

- confirming the meeting in advance;
- preparing and sending an agenda;
- collating the known data about the prospect and perhaps presenting this to the prospect in a graphical to demonstrate awareness of the prospect's business and risks;
- setting objectives for the meeting, particularly building rapport, understanding the business and gleaning as much as possible about the insurance and risk programme;
- using a prompt list of questions but allowing for flexibility – let the prospect lead;
- setting listening on maximum – let the prospect talk;
- recording the discussion in writing and confirm to the prospect;
- seeking actions that allow repeated contact; and
- ensuring that the outcome of all meetings is recorded in the broker's client relationship or prospect management system, with data to support the likelihood of the contact moving to the next stage.

A7 Developing the relationship

It is rare that an initial meeting leads to an appointment, especially for middle-market and larger prospects. Once the first meeting has taken place, the next step is to maintain and develop the relationship. Often, the first meeting will establish that there is no obvious dissatisfaction with the current arrangements or that there is no plan for a review in the near future. So the challenge is to keep the relationship warm in a way that does not irritate the prospect.

In the current market where conditions are generally soft and the economy is weak, many businesses will say that they do not have time for a review of their insurance programme. A range of techniques are available to deal with these issues and maintain the connection:

Project work: during the initial meeting an opportunity might be identified to undertake a specific project such as risk management exercise or in the case of a global, say a review of some aspect of insurance in another territory. Ideally, this should be done for a fee but sometimes speculation to accumulate is necessary.

Site visits: the prospect might be willing to organise visits to their locations to enable the broker to build a better understanding of the risk.

Events: ensuring that the prospect is invited to all relevant educational and promotional events such as seminars.

Regular communication: through publications of specific interest to the prospect.

Entertaining: inviting the prospect to lunch or dinner either alone or with other prospects and clients. This gives the opportunity to build rapport, introduce the prospect to other potential members of the broker's service team and possible other clients who may be willing to recommend the broker.

A8 Structured selling

There is a number of proprietary sales tools that assist businesses in selling to prospects. The purpose of these tools is to:

- identify the best opportunities, where there is a greater chance of winning – the objective is to enable scarce resources to be allocated where they yield the best returns;
- bring structure to the process of understanding how to match the needs and personality of the client with the skills and resources of the broker; an example is identifying that the prospect has an issue with say product recall and matching that with an area of acknowledged expertise within the broker; and
- identify the individuals at the prospect and how they will influence the outcome of the review. Terms are used such as economic buyer – the person who will most influence the buyer, the coach – the person who may not have the final decision but who will help the broker win the business.

A9 Managing the new business review and closing the deal

All firms must develop their own styles of managing reviews. The objective is to win. To ensure the greatest chance of success requires the firm adopts some standard processes:

Allocating a project manager to each case.	This ensures that everyone involved knows their responsibilities and milestone dates, that progress is monitored and to take responsibility for the timely delivery of reports.
Ensuring that all the resources of the firm are brought to bear.	
Adopting a common style and layout.	Some firms prefer a great deal of customisation of reports – this can work but requires more detailed supervision.
Ensuring that statements on issues where there are firm-wide policies are complied with.	
Ensuring that service teams are matched with the 'personality' of the client.	This is something that should be addressed as early in the review as possible; preferably, members of the service team should have met the prospect in advance of the actual review.
Ensuring that the written report is thoroughly checked for content, spelling and compliance with the brief and is delivered on time.	
Where the prospect has issued a tender document, making sure that all aspects of the tender are responded to.	For many larger risks there is a trend to use purchasing departments to manage tenders. These can be very prescriptive and require detailed and somewhat tedious responses that make it difficult for the broker to demonstrate flair and innovation.
Where a presentation is required, ensuring that the prospects requirements for timing are met and that there is clear agreement on the 'message' to be conveyed.	All participants should be prepared and rehearsed. Arrangements at the presentation location should be checked to ensure that technology is compatible. Ideally, especially where the prize is large, the presentation team should be organised to arrive early with nothing left to chance as far as transport is concerned.
There needs to be a compelling summary at the end of the presentation, summing up why the prospect should appoint the broker, indicating the benefits and broker's appetite to win.	

B Dedicated sales staff v. client servicing staff

This is a perennial question in sales: is it better to use client servicing teams or dedicated sales staff? The former are seen as more conservative and introverted characters whereas the latter are stereotypically characterised as extroverts and 'natural salespeople'. So does this mean that the main criterion for a successful salesperson is their personality? Are they born and not made? Debating nature versus nurture is outside the scope of this course but we can consider one of the typical analogies, **hunters and farmers**:

- **The hunter** is the person who gets their sales energy from the 'hunt' for the new opportunity. They are often consultative salespeople who innately find and assess an opportunity (even when there doesn't appear to be one) within a prospect, and find a solution within your offering that meets the specific need. They are networkers. They are independent. They generate a buzz and excitement. And, they are not always good at follow-through and focus.

Typical sales roles: Full-time sales, business development representatives/managers.

- **The farmer** is the salesperson who builds and cultivates relationships and opportunities, typically within existing accounts. Farmers are the salespeople who turn a customer from good to great by the nature of their relationship and the loyalty they gain from their efforts. They nurture. They collaborate. They are team players. And, they are not always good at prospecting.

Typical sales roles: account executives/directors.

When judging the right balance for a broker to truly succeed in sales, they need aspects of both of these character traits. The reason for this is if you have a sales team full of hunters, you may acquire new customers fairly quickly but experience high attrition in your existing business. And if you have a team full of farmers, you may have a loyal customer base but slower growth as new business may be harder to come by. Also, if you are a smaller company, you may need one person to wear both hats (hunting and farming).

While these combinations – the hunting farmer or the farming hunter – exist, they are harder to find. When found, they should be nurtured.

In successful sales, personality is important. Some people are better at the relationship skills that are required by good sales and servicing staff. However, it is essential that they have the right mix of experience, subject matter and process knowledge supported by a strong sales organisation and culture. What firms must avoid is believing that simply hiring a 'good salesperson' will ensure success. Very few individuals can achieve stellar results on their own. The best always work with a professional team infrastructure and process.

We should of course be careful about stretching this analogy too far. In human history, '**farmers**' have outcompeted '**hunters**' comprehensively. Agriculture is one of the underpinnings of human success.

C Incentivisation

The whole issue of bonuses is contentious, particularly in the light of the 2008 financial crisis and the huge bonuses paid to some banking staff. Bonuses are a general feature of the private sector and have become more common in the public sector, the latter tending to attract adverse comment, particularly suggestions that 'senior public officials are given bonuses to do their job properly, they rarely do a good job and junior staff get nothing...' This is not the place to resolve these issues. You should also note that this is an area of scrutiny by the FCA.

Refer to

Refer to *Senior Management Arrangements, Systems and Controls (SYSC)* on page 5/20 full explanation of SYSC

The implementation of the Markets in Financial Instruments Directive (MiFID) and Insurance Distribution Directive (IDD) has led to a strengthening of approach. In particular consider Senior Management Arrangements, Systems and Controls (SYSC) 10.1.3R (Identifying Conflicts) which states:



A firm must take all appropriate steps to identify and to prevent or manage conflicts of interest between:

1. the firm, including its managers, employees and appointed representatives (or where applicable, tied agents), or any person directly or indirectly linked to them by control, and a client of the firm; or
2. one client of the firm and another client;

that arise or may arise in the course of the firm providing any service referred to in SYSC 10.1.1R including those caused by the receipt of inducements from third parties or by the firm's own remuneration and other incentive structures.

Dedicated sales people tend to be heavily **incentivised**. A 'low' basic salary is paid with the bonus normally calculated by a formula that is some percentage of the new revenue achieved, provided that it has exceeded a minimum value. Some are capped and others are unlimited. This can work well for some individuals but the flaw is that nearly all new business

is the result of a team effort. How are the team members to be rewarded and in what proportion?

There will also be other people who contribute to the success of the firm but that can have little direct impact on sales. Often, if they receive a bonus, it will be from a general pool, according to criteria relevant to their job that should have been agreed in advance.

Finally, there is the generally idealistic view that people should not be rewarded for merely doing their job and that many people are not motivated by money. It would be fair to say that whatever merit this view might have, it is not one adopted by many brokers.

In an ideal system (which many rarely are):

- the whole bonus structure should be transparent to all;
- there should be a fair division of rewards;
- truly exceptional performance should receive exceptional rewards;
- everyone should remember that bonuses can go down as well as up;
- there should be a link to overall performance, whether within the specific division or the firm as a whole, and this link should be the larger component, the more senior the person;
- for large accounts where many people are involved, bonuses may not work since when spread amongst the whole team, the amounts may become derisory. This area needs more thought and should probably reflect overall team performance; and
- care must be exercised to ensure there is no evidence that a firm's incentive plan has caused a conflict of interest to the client's detriment.

Broking management decision: Incentives

Consider the arguments for and against a bonus system for new business and decide upon the structure of a bonus system that rewards all involved individuals fairly. Consider whether an incentive system acts against the concept of the fair treatment of customers and other Principles for Business.



D Building a sales culture

There is no instant way to do this and certainly no magic bullet. It will take time and persistence. It will be the result of doing many smaller things well rather than spectacular or rapid change. Some examples of the steps required include:

- ensuring all staff understand the strategy of the firm, where it wants to grow and focus its activities and resources;
- making sure that all staff are engaged, even if they do not have the specific job of developing business – this can be done by regular communication of activity and progress and the celebration of success;
- adopting a methodical and structured approach to the sales process as described above. More importantly, ensuring that the process is adhered to and that there is reward for good compliance as well as success. The converse is to ensure that where there is non-compliance, action is taken.
- senior level commitment and participation and support in terms of resource; monitoring of activity is vital; and
- ensuring that the people directly engaged in the sales process can and do focus on sales and are not distracted by other tasks or management responsibility. Explicit targets are essential.

E Volume sales

Volume sales relate to more generic products involving high-volume and low-cost insurance policies. These tend to be sold through the internet or call centres by less-specialised staff. Staff training tends to focus on sales techniques such as who/when to call, opening comments, engaging with the customer, building trust and dealing with objections.

Front-line staff need more support and encouragement to maintain enthusiasm for sales. Motivation may be reward or celebration through recognition of the individual or team on successful sales performance. Some call centres work from scripts and many have call recording and supervisor listening facilities.

Outbound sales teams tend to call potential customers from databases that have been purchased from a variety of organisations, or from related customer records or partner organisations. Customers may regard these calls as 'nuisance calls'.

The influx of call centres making unsolicited calls in relation to mis-selling of payment protection insurance (PPI), non-fault accidents and recent pensions changes has damaged the reputation of this sales method. While this sector is heavily regulated by data protection laws, distance marketing regulation, the FCA and telephone regulators, it is difficult to overcome some of the challenges.

Inbound calls are less challenging as the caller has chosen to contact the insurer or intermediary and is therefore seeking to make a purchase.

Sales staff tend to have no involvement with the customer after the sale and the administration is passed on to a separate team to process.

Internet sales can be more cost-effective for insurers and intermediaries as the processes are automated. However, this market is highly competitive and research has shown that consumers are using sites to benchmark costs, with fewer proceeding to purchase.

Schemes and affinity products can be effectively sold through trade associations or customer outlets, usually on a shared income basis with the sponsor, or member benefits such as enhanced cover or reduced cost. Reputable associations can enhance consumer confidence, which leads to increased sales and less churn.

Essential information for optimising the number and quality of sales in all volume sales environments includes an analysis of the source and quality of data, the sales approach (method, time of day, sales pitch etc.), location, team and individual staff.



Consider this...

Consider your own experiences of purchasing insurance through various channels and what factors influenced your decision to purchase.

Conclusion

The successful sales organisation integrates all that we have discussed; effective pipeline management with the right people. It instils a sales culture at all levels of the business and creates a feeling of 'ownership', responsibility and accountability in all levels of staff. The brokers that can reach these goals will achieve exceptional growth.

F Scenario 4.1: A sales plan

F1 Question

Your firm is a successful broker employing 25 people. Much of the success has been due to the drive of the two founding directors who have introduced much of the business and have retained responsibility for the larger clients. There is no organised sales process.

Now both are approaching retirement and you will be succeeding them as the senior director. You have to consider where the firm goes next and most importantly how it will grow through new business.

Describe the key issues that you need to consider.

F2 How to approach your answer

Key points

You should aim to include the following key points of content:

- A review of where the business is today with respect to prospect development.
- Capturing the contacts of the retiring directors through shadowing and strong client relationships.
- The cost of introducing a new sales process against the risk that the business starts to shrink.
- Look for the opportunity for referrals from existing clients.
- Consider whether new dedicated sales staff should be hired or whether existing service staff can lead sales.
- Review the reward process.
- Build a comprehensive sales plan.

Self-test questions

1. Summarise the techniques that can be used to manage a pipeline.
2. Describe the ways that cold calling can be managed.
3. Describe briefly structured selling.
4. What are the key components to effective incentivisation?

You will find the answers at the back of the book

5

Regulation and compliance – key aspects

Contents	Syllabus learning outcomes
Introduction	
A The FCA, the PRA and the FPC: Overview	2.1
B Handbook and Rulebook	2.1
C FCA approach to broker regulation	2.1, 2.3
D Threshold Conditions	2.1
E Senior Management Arrangements, Systems and Controls (SYSC)	2.2
F Approved persons and the fit and proper test	2.1, 2.3, 2.4
G Prudential Standards	2.1, 2.3
H Insurance Conduct of Business (ICOBS)	2.2, 2.3, 2.4, 2.6
I Client Assets Sourcebook (CASS)	2.1
J Discipline and enforcement	2.4
K Product Intervention and Product Governance Sourcebook (PROD)	2.4, 2.8, 2.10
L Passporting	2.1, 2.3, 2.8
M Scenario 5.1: Approved persons	
Self-test questions	

This chapter relates to **syllabus section 2**.

Learning objectives

On completion of this chapter and your own private research, you should be able to:

- explain the regulatory environment and the approach to regulation;
- explain the implementation and control with respect to Senior Management Systems and Controls (SYSC) and ICOBS; and
- explain the disciplinary procedures to which insurance brokers are subject and their implications.

Introduction

In this chapter we examine the key aspects of UK regulation including the powers of the FCA, its overall approach to regulation and the way that is subtly different from the FSA's approach. Much of the original detail of FSA regulation has been transferred almost unaltered to the new FCA Handbook. However, there are some important changes, which are described in more detail below. The key areas of change are:

- the FCA's objectives; and
- the FCA's approach to risk assessment.

The Principles for Businesses (the guiding hand of the regulation); High Level Standards; Senior Management Arrangements, Systems and Controls (SYSC) and Discipline and Enforcement, are largely unchanged. Chapter 6 will review some of the practical application of the regulation and also other law that affects brokers.

Although you have already studied regulation in course M81, this treatment is focused on the key management issues in responding to the regulatory environment.

The FCA continues to target specific areas through a programme of thematic reviews. Following the UK general election in May 2015, they published the findings of three major reviews in the areas of consumer vulnerability, premium finance and the retail claims review, and delegating authority. You should visit the FCA website to keep up to date on activity and publications.

The different approach of the FCA was summarised in a speech given by Simon Green, then Head of General Insurance and Protection at the FCA, at the Incisive Media Insurance Age Regulation event, London, in 2013.

It is worth reading this speech as it sets the priorities and the approach of the FCA. Some of the key issues, such as the replacement of the ARROW visit with a new risk-based framework, are described in more detail throughout this chapter. Where relevant, extracts from the speech have been used to illustrate a point.

This speech is reproduced in full in appendix 5.1 and you can find it on RevisionMate.

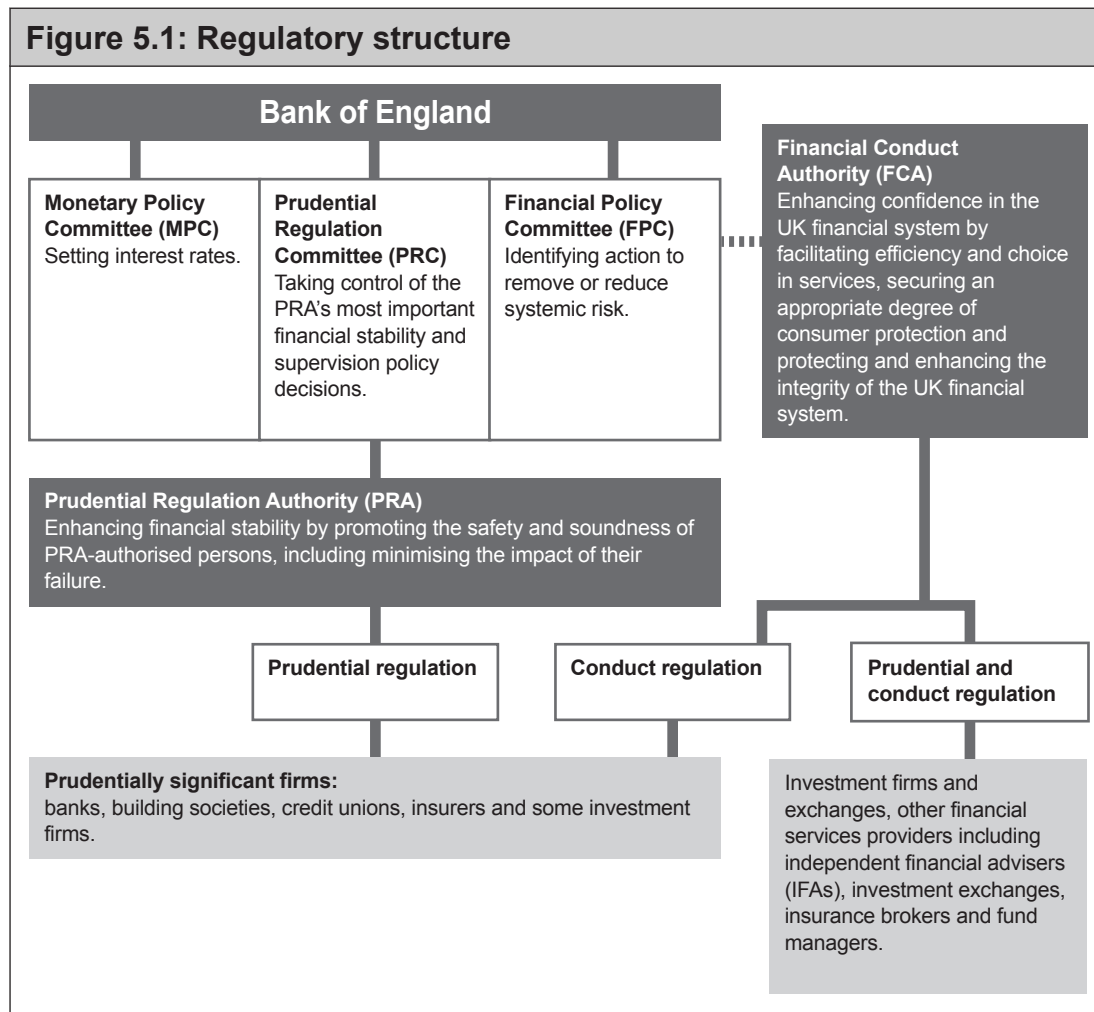


Key terms

This chapter features explanations of the following terms and concepts:

Appropriate resources	Approved persons	Authorisation	Business Standards
Client Assets	Compliance	Conflicts of interests	Financial Conduct Authority
Financial Services Act 2012	Fit and proper test	Insurance Conduct of Business	Principles for Businesses
Supervision	Systems of Senior Management Arrangements, Systems and Controls	Threshold Conditions	

Figure 5.1 illustrates the current regulatory regime.

Figure 5.1: Regulatory structure

Changes to the regulatory structure

The **Bank of England and Financial Services Act 2016** modified the *Financial Services Act 2012*. The 2016 Act puts the Bank of England at the heart of UK financial stability by strengthening the Bank's governance and ability to operate more effectively as 'One Bank'.

The status of the FCA remained unchanged (as a subsidiary organisation of the Bank of England) but the PRA was made part of the Bank (ending its status as a subsidiary) and a new **Prudential Regulation Committee (PRC)** has been established. The PRC operates alongside the other two Bank committees, namely the **Financial Policy Committee (FPC)** and the **Monetary Policy Committee (MPC)**.

A The FCA, the PRA and the FPC: Overview

The Financial Services Act 2012 gained Royal Assent in December 2012 and from 1 April 2013 three new financial services regulatory bodies were established.

Financial Conduct Authority (FCA):

- A separate independent regulator responsible for **conduct of business and market issues** for all firms and prudential regulation of those not supervised by the Prudential Regulation Authority (PRA), such as **insurance brokerages** and financial advisory firms.
- The FCA is focused on taking action early, before consumer detriment occurs.
- There has been a shift towards thematic reviews and market-wide analysis to identify potential problems in areas such as financial incentives.
- The FCA will review the full product lifecycle from design to distribution with the power to ban products or features of products where necessary.

Prudential Regulation Authority (PRA):

- The PRA sits within the Bank of England and its role is defined in terms of three statutory objectives:
 1. A general objective to promote the safety and soundness of the firms it regulates.
 2. Specifically for insurers, to contribute to the securing of an appropriate degree of protection for those who are or may become insurance policyholders.
 3. A secondary objective to facilitate effective competition.
- In promoting safety and soundness, the PRA focuses primarily on the harm that firms can cause to the stability of the UK financial system. A stable financial system is one in which firms continue to provide critical financial services.
- The PRA will place emphasis on a 'judgment-based' approach to *supervision* focusing on: the external environment, business risk, management and governance, risk management and controls, and capital and liquidity.

Financial Policy Committee (FPC):

- A committee within the Bank of England, which is charged with a primary objective of identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system.
- The FPC has a secondary objective to support the economic policy of the Government.
- The FPC has the power to use so-called 'macro-prudential tools' to counteract systemic risk. The tools might include imposing leverage limits on banks or enforcing particular capital requirements for given asset classes.
- With the Bank of England now in charge of micro- and macro-prudential regulation, on top of its responsibilities for monetary policy, it is fast becoming one of the world's most powerful central banks.

**On the Web**

FCA: www.fca.org.uk.

PRA: www.bankofengland.co.uk/pru.

FPC: www.bankofengland.co.uk/about/people/financial-policy-committee.

We will now discuss the FCA, the PRA and the FPC in more detail.

A1 Financial Conduct Authority (FCA)

Chief executive: Nikhil Rathi who took over from Andrew Bailey in October 2020.

A1A Scope

The FCA regulates the conduct of approximately 59,000 businesses. This includes the following:

- Firms solely regulated (for prudential and conduct issues) by the FCA. These are firms that are deemed of limited systemic importance. Examples include: personal investment firms, investment management firms, mortgage and insurance intermediaries, authorised professional firms, providers of market trading infrastructure, and non-bank mortgage lenders. It will also include Lloyd's members' agents and Lloyd's brokers.
- Firms regulated purely for conduct of business issues. These firms, deemed to be systemically important, are prudentially regulated by the PRA and conduct regulated by the FCA. They include banks, building societies, credit unions, general insurers and life insurers, Lloyd's and Lloyd's managing agents.
- Firms regulated under other legislation. These are electronic money institutions and payment institutions.

The FCA has taken over the FSA's responsibility for the Financial Ombudsman Service; it oversees the Money and Pensions Service, and also has responsibility for the Financial Services Compensation Scheme. The Treating Customers Fairly (TCF) initiative has also been taken forward by the FCA, and is now referred to as the 'fair treatment of customers'. The Money and Pensions Service was launched in January 2019 to provide a single guidance body after combining the previous The Money Advice Service, The Pensions Advisory Service and Pension Wise.

A1B Objectives

The Financial Services Act 2012 states that the FCA has an overarching strategic objective to **‘ensure that the relevant markets function well’**.

It has three operational objectives:

- **Consumer protection:** securing an appropriate degree of protection for consumers.
- **Integrity:** protecting and enhancing the integrity of the UK financial system.
- **Competition:** promoting effective competition in the interests of consumers in the markets for:
 - regulated financial services; and
 - services provided by a recognised investment exchange.

Additional factors that the FCA (and PRA) must have regard to include:

- efficient and economic use of resources;
- proportionality;
- consumer responsibilities; and
- transparency.

A1C Changes to the FCA’s general approach to regulation

Product intervention and governance: the FCA’s aim is to be more proactive than the FSA and will ‘intervene earlier in the product’s life span and seek to address root causes of problems for consumers’. Powers can include temporary intervention rules and product pre-approval. This is discussed in more detail below.

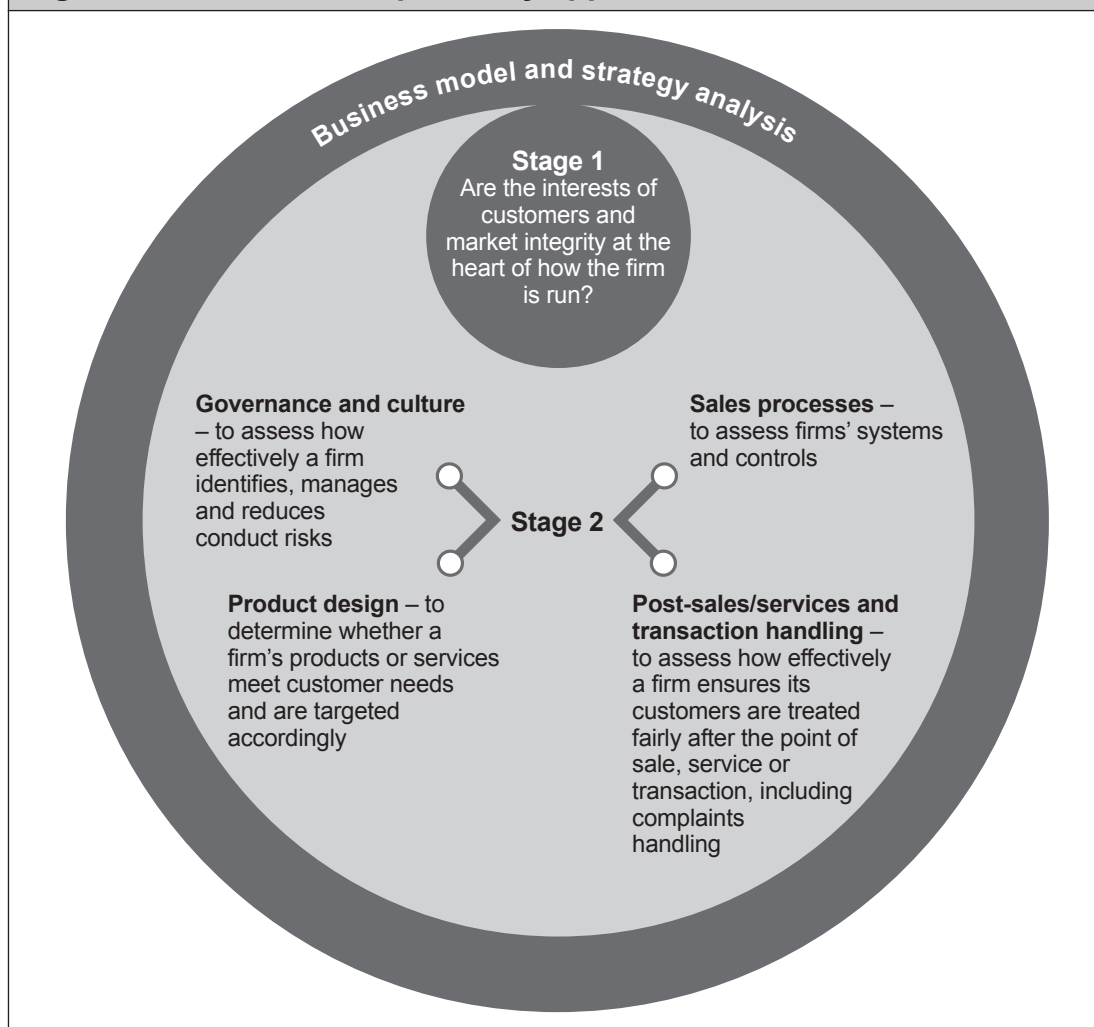
Super-complaints: the FCA is a body that is able to review and react to detailed submissions by consumer groups that have been designated as ‘super-complainants’ by HM Treasury. Previously only the Office of Fair Trading could receive these ‘super-complaints’ highlighting systematic problems in particular markets. Previous submissions have led to inquiries from the Competition Commission into payment protection insurance and extended warranties.

Competition powers: the FCA’s competition objective – to promote effective competition in the interests of consumers means:

- firms must compete for business by offering better services, better value and types of products that customers want and need;
- prices offered are in line with costs; and
- firms will innovate and develop new products over time: the FCA will draw a distinction between ‘good’ innovation that meets consumers’ genuine needs and other types that exploit consumers.

A1D The FCA's approach to supervision

Figure 5.2: The FCA's supervisory approach



General principles: the supervisory system is designed so that firms are encouraged 'to base their business model, culture and how they run the business on a foundation of 'fair treatment of customers' principle. The system 'will act more quickly and decisively and be more pre-emptive in identifying and addressing issues before they cause harm, with senior staff involved in decisions at an early stage'.

Supervisor organisation: this approach requires a more flexible focus on bigger issues as they emerge, either in individual firms or across sectors. This will mean that some larger-risk firms might have an assigned supervisor with highly intensive contact, whereas others might be contacted once every three to four years.

Firm categorisation: The system originally covered risk categories C1 (large banking and insurance groups with very large number of retail customers) through to C4 (smaller firms including most intermediaries). However, the FCA announced in September 2015 that it was making further changes to its supervisory model, including how it classified firms, to support the sector-based approach introduced as part of its 'New Strategy' in 2015.

The FCA will continue to look at the way individual firms and people behave, but will also increasingly look at how markets work as a whole, with greater emphasis on sector and market-wide analysis. Part of the change to the FCA model is a move away from C1 to C4 conduct categories that it has previously used; instead, firms will now be categorised as either 'fixed portfolio' or 'flexible portfolio'.

The FCA approach will vary depending on the risks it has identified in each sector, but may mean that, over time, some firms will see changes to how they are supervised. The reclassification meant that around 70 firms moved from 'fixed' to 'flexible' portfolio or from 'flexible' to 'fixed'.

On the Web

For more information on firm categorisation you can find the FCA's guidance here:
www.fca.org.uk/publication/other/factsheet.pdf.



The following is taken directly from **SUP 1A.3 – The FCA's approach to supervision**.

The FCA's approach to supervision



SUP 1A.3.1 G

The FCA will adopt a pre-emptive approach which will be based on making forward-looking judgments about firms' business models, product strategy and how they run their businesses, to enable the FCA to identify and intervene earlier to prevent problems crystallising. The FCA's approach to supervising firms will contribute to its delivery against its objective to protect and enhance the integrity of the UK financial system (as set out in the Act). Where the FCA has responsibilities for prudential supervision, its focus will be on reducing the impact on customers and the integrity of the financial system of firms failing or being under financial strain. In addition, when consumer detriment does actually occur, the FCA will robustly seek redress for consumers. This approach will be delivered through a risk-based and proportionate supervisory approach.

SUP 1A.3.2 G

The overall approach in the FCA supervision model is based on the following principles:

1. forward-looking and more interventionist;
2. focused on judgment, not process;
3. consumer-centric;
4. focused on the big issues and causes of problems;
5. interfaces with executive management/boards;
6. robust when things go wrong;
7. focused on business model and culture as well as product supervision;
8. viewing poor behaviour in all markets through the lens of the impact on consumers;
9. orientated towards firms doing the right thing; and
10. externally focused, engaged and listening to all sources of information.

The scope of the supervision model for firms

SUP 1A.3.3 G: the FCA supervision model risk assessment process applies to all firms, although the detail required may vary from firm to firm. For example, some firms may experience a highly intensive level of contact although others may only be contacted once every four years. Firms judged as high impact are likely to require a more detailed assessment. A peer review process within the FCA assists consistency and will be focused on firms and sectors of the industry that could cause, or are causing, consumers harm or threaten market integrity.

SUP 1A.3.4 G: the supervision model is based on three pillars:

1. The Firm Systematic Framework (FSF) – preventative work through structured conduct assessment of firms.
2. Event-driven work – dealing with problems that are emerging or have crystallised, and securing customer redress or other remedial work (e.g. to secure the integrity of the market) where necessary.
3. Issues and products – thematic work on sectors of the market or products within a sector that are putting or may put consumers at risk.

The FCA intends to raise standards and plans to do this by ensuring that firms fully understand its evaluation of risk. To do this, the FCA will communicate the results of each pillar of supervision. The FCA also expects these risk assessments to be kept confidential to the firm and the FCA.

To quote Simon Green, Director of General Insurance and Protection at the FCA:



Thematic work

Thematic work is fundamental to the way we supervise the general insurance market. We undertake thematic projects to assess current and future risks in relation to a particular issue or product. This may be across a number of firms, within a specific part of the sector, or at market level.

Our recent projects on mobile phone insurance, motor legal expenses insurance and premium finance characterise our approach – working with the insurance industry and its customers to deliver better outcomes for customers.

Source: Financial Conduct Authority (2013) *What does the future of insurance broking look like?* Available at:

www.fca.org.uk/news/future-of-insurance-broking.

The majority of brokers, who fall into the flexible portfolio category, are likely to feel more impact from the thematic reviews.

At the other end of the spectrum, the largest broking firms receive very close supervision and frequency of contact with the FCA that may be as often as weekly. This requires considerable effort and cost in the form of *compliance* and risk management functions. There is also the time that must be spent by senior management in attending the relevant committees and ensuring a thorough understanding within the business of the key issues from the regulation.

The FCA will look to see that these firms encourage a culture of ‘doing things the right way’ in order to meet the FCA’s requirements but also to serve clients in the most appropriate manner.

A1E Earlier intervention

The FCA has powers to intervene to prevent detriment occurring. The Financial Services Act 2012 confirms a number of regulatory initiatives to shift the balance from tackling the symptoms of consumer detriment to the ‘root causes’. Examples include:

Banning products (applies to the retail sector)

- Where the FCA identifies a serious problem with a product or product feature, it will be able to take timely and necessary steps to ban it.
- The legislation enables the FCA to make temporary product intervention rules without prior cost-benefit analysis or consultation valid for up to twelve months.
- The FCA released a policy statement on its use of temporary product intervention at: www.fca.org.uk/publication/policy/fsa-ps13-03.pdf.
- The FCA is only allowed to use its product intervention powers in relation to retail customers.

Withdrawing misleading financial promotions

The FCA can take action in relation to misleading financial promotions. It can also disclose the fact that enforcement action against a firm or individual has commenced.

It is required to alert a firm to its proposed course of action, and to allow for and consider representations by firms before publishing any details of its action.

Publication of enforcement action

The previous regulator was already being more proactive about enforcement, and in 2011/12 there had been a marked increase in the intensity and incidence of enforcement actions.

The FCA will drive this forward with even greater intensity, bringing more enforcement cases and pressing for tougher penalties, and being more willing to pursue cases against individuals including senior management.

The FCA is able to publish the fact that a warning notice has been issued about a firm as well as a summary of the notice. This new power is available to both the FCA and PRA.

In making a decision about whether or not to disclose the warning notice, the regulator must consider a number of factors including whether publication of the information would be unfair to the person to whom the warning notice relates, where that party can provide ‘clear and convincing evidence of how that unfairness may arise and how they could suffer a disproportionate level of damage’.

Market intelligence gathering and research

The FCA has a Policy, Risk and Research Division that will ‘combine research into what is happening in the market and to consumers with better analysis of the type of risks where they appear.’ It will be the ‘radar’ of the organisation:

- It will identify and assess risks to consumers, creating a common view to inform the FCA’s supervision, enforcement and authorisation functions.
- While relying on existing sources for evidence including consumer groups, the media and ongoing market monitoring and analysis, more use will be made of the consumer action line.

In focus: The FCA’s thematic and proactive approach

The FSA had said that its investigation and subsequent guidance consultation on financial incentives was an example of the type of work that the FCA will be undertaking going forward. Following a thematic review of sales practices across retail financial services firms including banks, financial advisory firms and insurers, the regulator found that 20 out of 22 firms assessed did not properly identify how their incentive schemes might encourage staff to mis-sell. Indeed it was found that many firms did not understand their own incentive schemes because they were so complex, making the schemes hard to control.

As a result of the findings, the consultation noted that the FCA would consider strengthening the rules in the area of financial incentives. In the meantime, in order to help ensure better practice, the consultation set out the types of incentive schemes that might increase the risk of mis-selling and provided information on best practice in terms of the governance of incentive schemes.

The financial incentives work is a clear indication of the likely direction for the FCA – with a more ‘proactive’ interventionist remit using thematic reviews to focus on the culture of firms from product governance to front line sales. Through future supervisory visits and thematic reviews, the regulator will be looking for evidence that firms put the interests of consumers at the heart of what they do.

For more information about the approach to handling financial incentives see FSA’s final guidance *Risks to customers from financial incentives*:

www.fca.org.uk/publication/finalised-guidance/fsa-fg13-01.pdf.



Authorisation and approvals

While the fundamentals of the FSA’s authorisation function remain, the FCA focuses on the proposed business model, governance and culture, as well as the systems and controls the firm intends to put in place especially over:

- product governance;
- end-to-end sales processes; and
- prevention of financial crime.

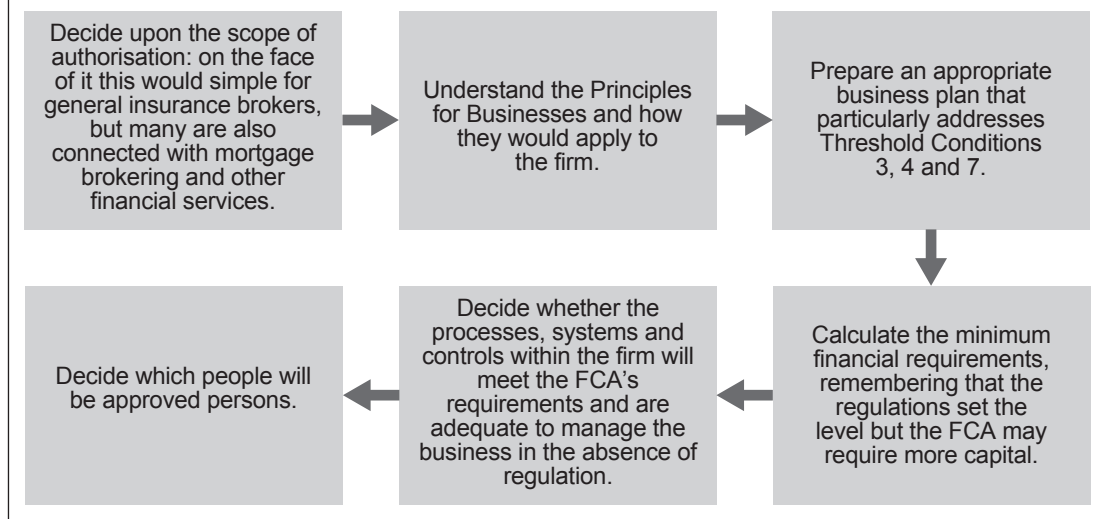
The FCA also works closely with the PRA in considering applications to approve individuals to roles in dual-regulated firms, which have a material impact on the conduct of a firm’s regulated activities. The FCA will seek to assess that applicants have a good understanding of how to ensure good outcomes through:

- corporate culture;
- conduct risk management; and
- product design.

Applicants will also be assessed on:

- honesty, integrity and reputation;
- competence and capability; and
- financial soundness.

Figure 5.3 summarises the route to authorisation based on the above.

Figure 5.3: Route to authorisation**Accountability**

- The FCA is required to report annually to Government and Parliament.
- There is oversight of the FCA's work by a board appointed by the Government with a majority of non-executive directors.
- The Financial Services Act 2012 contains a provision for independent reviews of the efficiency and effectiveness of the FCA's use of resources.
- There is also a requirement for the FCA to make a report to the Treasury in the event of a regulatory failure and where this failure was due to the FCA's actions.
- However, it is noted that the obligation to publish a report, and the desirability of transparency, should not impede or prejudice the FCA's ability to pursue enforcement investigations. In such circumstances, publication would be delayed until enforcement action is completed.

Engagement with consumers

- The FCA will seek to build a better understanding of consumer behaviour, consumer needs and consumer experiences to shape how it designs its interventions.
- It will also engage more with consumers directly, including through social media, consumer bodies, road shows, focus groups and face-to-face contact.
- Finally, the FCA will collect and analyse consumer information from other sources such as complaints, including those investigated by the Ombudsman, and external commercial, academic and public interest research.

Transparency and disclosure

- The FCA is required to put in place **four statutory panels** representing the views of consumers, regulated firms, smaller regulated firms and market practitioners.
- It will build on the FSA's approach to consultation as part of the rule-making process and will seek to develop more effective ways of getting feedback on proposals, including from consumers and their representatives.
- It will publish more information about its views on markets (key trends, products and services) and the comparative performance of a firm.
- It will recognise that necessary restrictions on disclosure exist in UK and EU law. However, where disclosure of information would be incompatible with the FCA's objectives, **the FCA will not have to disclose information.**

A2 Prudential Regulation Authority (PRA)

Chief Executive: Sam Woods

A2A Scope

The PRA is responsible for the prudential regulation of all 'systemically important firms' defined as those firms that pose a risk to the financial system if they were to fail. The PRA is responsible for the regulation of all institutions that accept deposits or which accept insurance contracts. This will mean that the PRA will authorise and supervise all banks,

building societies, credit unions, general insurers and life insurers (but not insurance intermediaries).

The PRA has three objectives:

- a general objective to promote the safety and soundness of the firms it regulates;
- an objective specific to insurance firms, to contribute to the securing of an appropriate degree of protection for those who are or may become insurance policyholders; and
- a secondary objective to facilitate effective competition.

In relation to its objective specific to insurers, the PRA also has a specific responsibility to secure an appropriate degree of protection for the reasonable expectations of policyholders as to the distribution of surplus under with-profits policies.

A2B Threshold Conditions

The 'Threshold Conditions' will be the minimum requirements that firms must meet in order to be permitted to carry on regulated activities. The Threshold Conditions for which the PRA will be responsible are designed to promote safety and soundness, and firms must ensure that they meet them at all times. Threshold Conditions will be covered in more detail in [Threshold Conditions](#) on page 5/19.

A2C Judgment-led regulation

The PRA's judgment-led approach to supervision will be characterised by a move away from rules and a focus on forward-looking analysis including an assessment of how a firm would be resolved if it were to fail, the impact this would have on the system as a whole and the use of public funds. The aim is therefore to 'pre-empt risks before they crystallise'. Central to the new approach is a new risk assessment framework.

A2D Risk assessment framework

The new framework (as shown in figure 5.4) will operate in a way that reflects the PRA's additional objective to protect policyholders as well as the financial system. The framework captures three elements:

1. The potential impact on policyholders and the financial system of a firm coming under stress of failing.
2. How the macroeconomic and business risk context in which a firm operates might affect the viability of its business model.
3. Mitigating factors, including risk management, governance, financial position including its solvency position and resolvability.

Figure 5.4: The PRA's risk framework

Gross risk			Mitigating factors				
Potential impact	Risk context		Operational mitigation		Financial mitigation		Structural mitigation
Potential impact	External context	Business risk	Management and governance	Risk management and controls	Liquidity	Capital	Resolvability

Source: Prudential Regulation Authority (2016) *The Prudential Regulation Authority's approach to insurance supervision*. Available at: bit.ly/2zmkmw5.

A2E The intensity of supervision

The intensity with which firms will be supervised by the PRA will depend on their level of riskiness related to the areas above.

However, all firms will face at least a **'baseline level of monitoring'**. This will involve:

- ensuring compliance with prudential standards for capital;
- liquidity, asset valuation, provisioning and reserving;
- at least an annual review of the risks posed by firms or sectors to the PRA's objectives; and
- assessing a firm's planned recovery actions and how it might exit the market.

A2F Proactive Intervention Framework (PIF)

The PRA's judgment about proximity to failure will be captured in a firm's position within the **Proactive Intervention Framework (PIF)**. Judgments about a firm's proximity to failure will be derived from those elements of the supervisory assessment framework (see figure 5.4) that reflect the risks faced by a firm and its ability to manage them — namely, external context, business risk, management and governance, risk management and controls, capital and liquidity.

There are **five** clearly demarcated PIF stages, each denoting a different proximity to failure, and every firm will sit in a particular stage at each point in time. As a firm moves to a higher PIF stage — i.e. as the PRA determines that the firm's viability has deteriorated — supervisors will review their supervisory actions accordingly. Senior management of firms will be expected to ensure they take appropriate remedial action to reduce the likelihood of failure, and the authorities will ensure appropriate preparedness for resolution.



In focus: Firms' culture and prudential supervision

The PRA will expect insurers to have a culture that supports their prudent management.

In summary, under the PRA:

- **firms** must have sufficient controls to minimise excessive risk taking;
- **insurers and individuals** must behave in an open and co-operative manner; and
- **an insurer's board** must take responsibility for establishing, embedding and maintaining the type of culture described above.

The PRA's supervisory approach suggests that firms will face increased scrutiny the more their organisational culture fails to demonstrate a strong, joined-up model to managing the prudential risks related to their business. Supervisors will assess risks using expertise and judgment rather than box-ticking.

It is therefore up to firms to show how their organisation is managing prudential risks appropriately — no one approach to risk management will be right for everyone. If firms fail to do this they could find themselves facing greater intervention from the regulator as they move up the PIF.

A2G Regulation of Lloyd's of London

The PRA is the lead regulator for Lloyd's as a whole although the FCA will take responsibility for certain conduct of business issues. The legislation confirms that 'The Society of Lloyd's and Lloyd's managing agents will be dual regulated firms; Lloyd's members' agents and Lloyd's brokers will be FCA-regulated firms'.

A3 Financial Policy Committee (FPC)

Governor: Andrew Bailey who took over from Mark Carney in March 2020.

A3A Scope and objectives

Run by the Bank of England, the FPC has responsibility for macro-prudential supervision. It is responsible for spotting the systemic risks 'attributable to structural features of financial markets or to the distribution of risk within the financial sector'. It is also responsible for identifying unsustainable levels of leverage, debt or credit growth.

Having identified the risks, the FPC will have the power to take various policy measures to counteract them.

Examples of so-called macro-prudential tools include the following:

- **Setting countercyclical capital buffers:** ensuring that banks increase their capital in the 'good times' so they have protection for the bad. This should also have the effect of tempering lending during a boom and so dampening the effect of the credit cycle.
- **Variable risk weights:** enforcing targeted capital requirements on specific sectors or asset classes. This could include requiring banks to hold greater levels of capital against asset exposures that represent substantial risk.
- **Leverage limits:** limiting excessive build-up of on and off balance sheet leverage. Since measures of risk can be unreliable, a leverage ratio could act as a back-stop to risk-weighted requirements (such as a capital buffer).

As well as these financial stability considerations, the FPC also has a statutory obligation to limit the impact of its policies on economic growth.

B Handbook and Rulebook

On 1 April 2013 the FSA Handbook was split between the FCA and the PRA. It now forms the FCA Handbook and the PRA Rulebook. Most provisions in the former FSA Handbook have therefore been incorporated into either the PRA's Rulebook, the FCA's Handbook, or both, in line with each regulator's set of responsibilities and objectives.

On the Web

The Handbook and Rulebook can be found at: www.handbook.fca.org.uk/handbook and www.prarulebook.co.uk.



FCA has said that over time the way its principles, rules and guidance are presented will inevitably change, and it will review the way it presents material to make it more 'user-friendly and accessible'. The FCA and PRA will need to cooperate, coordinate and consult over proposed changes to rules and requirements. The FCA has also said that it wants to issue more concise and clearer guidance than previously.

B1 Coordination

Given the potential for regulatory overlap between the FCA and PRA, the legislation provides a number of general coordination mechanisms:

- A statutory duty on the PRA and the FCA to coordinate their activities (including consulting with one another to gather views where necessary).
- An obligation to prepare a **Memorandum of Understanding** (including setting out the role of each regulator and how they are interlinked).
- Cross-membership of boards.
- A veto mechanism for the PRA to reduce the risk of regulatory actions threatening financial stability or the disorderly failure of a firm. See below 'in focus' box for more details.
- A requirement that the PRA and FCA include in their annual reports an account of how they have co-ordinated during the year.
- The regulators have also set out a MOU on with-profits business between the PRA and FCA.

In focus: The PRA's veto power

The PRA's power of veto ensures that the new regulatory regime can, at certain times of stress, prioritise financial stability over consumer protection. According to the Financial Services Act 2012, the PRA can direct the FCA to refrain from particular action if it believes that action might threaten financial stability or result in the failure of a PRA-authorised person.

In 'normal times', free of serious economic stress, there is arguably little risk of the veto being invoked. But it is far from certain how it will be used during episodes such as the recent financial crisis. Questions remain about when the PRA will decide to invoke this power and what effect this will have on customers.



In the following sections we will examine some of the key aspects of the regulation.

C FCA approach to broker regulation

The FCA's regulatory approach was set out in a speech by Simon Green, the Head of General Insurance and Protection at the FCA from 2013 to 2017. It is summarised here as follows:



To make markets work well the FCA will have a new style of regulation – not just new formal powers embodied in legislation, but a new approach to regulation. Not regulation through the rear-view mirror – but forward-looking regulation that asks:

- What are the current and future trends that impact the broker model?
- What are the key drivers of profitability?
- Which lines or activities are growing or shrinking?
- Where is product change or innovation driving?

Fundamentally, what does this mean for customers? Does this show that the market is working well, are customers at the heart of a firm's business? Being forward-looking means regulation based on judgment, not box-ticking. For example, brokers should be asking if this outcome is good for their customer, not if this sale is compliant with a narrow set of rules; or if the culture is right, not whether they have an adequate governance structure.

Firms should expect forward-looking, market-intuitive and judgment-based supervision from the FCA, including:

- a focus on senior management;
- enhanced analysis of the sector and insurer and brokers' business models;
- challenging providers on the value-for-money of their products, checking that charging structures can ensure good outcomes for customers; and
- thematic work.

Clarifying the difference between rules, guidance and other best practice

During 2014 the FCA introduced guidance on how it uses certain terms to distinguish between rules, guidance and other best practice:

- It uses 'must' where provisions are mandatory, because they are required by legislation or FCA rules.
- It uses 'should' to describe how it would normally expect a firm to meet its obligations (acknowledging the possibility the obligations could be met in other ways).
- It uses 'may' to describe examples of good practice that go beyond basic compliance.

This may have the effect of elevating the importance of guidance where, in the past, some firms have taken the view that guidance could be considered as 'nice to have', but only the actual rules really mattered. The FCA has made it clear that this is not the case going forward.

C1 FCA's annual *Business Plan 2019/20*

On the 17th April 2019 the FCA launched its business plan for 2019/20, which sets its priorities for regulating the financial services industry over the next 12 months. The FCA's aim for providing the business plan is motivated by its need for openness and transparency. However much of the plan is poorly understood, mainly due to the fact that many who should understand it, do not give it enough attention. You should access and read the full business plan on the link provided below, the relevant points are summarised here:

EU Withdrawal

For the 2019/2020 plan, the FCA like most firms it regulates is confronted with a difficult challenge of balancing the Brexit activities with its wider business activities of regulation in the market work, with a major share of its resources being prioritised on the UK's withdrawal from the EU. At the moment Brexit has two scenarios, leave without an agreement, where there is no transition period, or leave with the deal agreed where there is a transition period.

A transition or implementation period would be expected which is obviously in the interest of all parties. Firstly, because of the time to understand the relationship between the UK and the EU so that remedies can be put in place for the risks that could arise from a sudden change in that relationship, so-called 'cliff-edge' risks. And secondly, it is surely better to have a period needed to prepare for that future relationship knowing what it will be.

Cliff-edge risks arise in large part if there is a sudden and disorderly falling away of the passporting system without having an effective plan to bridge to the future. The passporting system goes both ways between the UK and the EU, so both sides have a strong interest in an orderly transition.

The risks of not getting this right are considerable, because without passporting the authorisations of those firms that rely on it fall away in the market into which they passport, unless some other action is taken. This matters because the authorisation provides the legal basis to continue to service existing contracts in many EU countries including the UK.

In insurance, servicing a contract means the legal basis to pay on claims to policyholders and receive premiums from them. This could affect £27bn of insurance liabilities and 10 million UK policyholders and around £55bn of insurance liabilities and 38 million policyholders in the rest of the European Economic Area (EEA) – not a small issue.

Many financial services firms are passporting in and out of the UK under EU Directives. The Insurance Mediation Directive (IMD) has the most passports (both ways) – there are 2,775 insurance brokers with passports to trade in the EU and 5,853 passporting into the UK. Mostly they are so-called services passports, involving cross-border selling with no branch presence in the UK, although it is not known how many of them are in active use.

As a backstop assurance for policyholders in the UK, in December 2017, the Government committed to legislate to allow insurance companies from the rest of the EEA to continue to service insurance policies held by UK-based customers by creating a regime of temporary permissions. However, it is hoped that we will see an agreement between the UK and the EU which means the backstop is not needed, and instead we have a permanent commitment to open financial markets.

Such a temporary permissions regime implemented in the UK cannot cover customers in the rest of the EEA with policies from a passported UK insurer.

At present, such customers are reliant on their UK insurance company transferring existing contracts to legal entities located in the EU, a more complicated process. Any change or backstop arrangement here is in the gift of the EU not the UK. It is hoped that there will be progress soon to deal convincingly on both sides with these transaction risks.

Cross-sector priorities

There are seven cross-sector priority areas the FCA has identified, based on its assessment of where intervention can have the greatest impact, or where there is the greatest harm or potential for harm to its objectives. Some areas are more closely related to general insurance than others, so this synopsis initially covers them all then focuses on those specific to it, providing more detail by drawing on the FCA's latest *Sector Views 2019* publication as well as the *Business Plan*.

- 1. Firms' culture and governance**
- 2. Operational resilience**
- 3. Financial crime (fraud scams) and anti-money laundering (AML)**
- 4. Fair treatment of existing customers**
- 5. Innovation, data and data statistics**
- 6. Demographic change**
- 7. Future of regulation**

These priorities are important for the UK financial services sector but not necessarily unique to general insurance. The business plan also has priorities by sector. The FCA's key priorities relating to general insurance and protection are:

- Fairness in pricing and product value.
- General insurance pricing practices.
- Poor governance and oversight in the distribution chain.
- Access and exclusion in insurance.

You can read the detailed outline of these priorities on p.41 of the FCA's Business Plan. You should read about all the cross sector priorities in the Business Plan and the Sector Views in more detail.



On the Web

You can read the full FCA's 2019-2020 Business Plan here:

<https://www.fca.org.uk/publication/business-plans/business-plan-2019-20.pdf>.

You can read the Sector Views 2019 publication here:

<https://www.fca.org.uk/publication/corporate/sector-views-january-2019.pdf>.

Insurance Distribution Directive (IDD)

One of the most significant regulatory changes in 2018/19 is the implementation of the Insurance Distribution Directive (IDD) which came into force on 1 October 2018. The IDD will help reduce conflicts of interest and ensure firms act in consumers' best interests. It should reduce the risk that firms will sell unsuitable products to consumers. It requires firms to identify the target audience for products to ensure they are designed to meet these consumers' needs, and regularly review these products to ensure they continue to do so.

Wholesale insurance sector

There have been significant changes in the wholesale insurance sector. Recent years have seen brokers developing new services and business practices. Given these changes, the FCA has been exploring how well competition is currently working and whether it could work better in the interests of clients.

In November 2017 the FCA launched the Wholesale Insurance Broker Market Study (MSM17/2). The Wholesale Insurance Broker Market Study (MSM17/2) assessed whether use their bargaining power to get clients a good deal, if any conflicts of interest exist and how broker conduct affects competition. The study looked at the role played by insurance brokers, the competition within the sector and how the market is developing and responding to the ever changing business environment.

The study, as set out in the FCA's terms of Reference, focused on the following main topic areas:

- market power;
- conflicts of interest: and
- broker conduct.

The FCA concluded its study and published its Wholesale Insurance Broker Market Study: Final Report (MS17/2.2) in February 2019. The Final Report has been positive news for the broking sector, the regulators study focused on five areas in the end which included:

- market power;
- pay to play;
- onerous conditions in contractual agreements;
- broker conflicts; and
- broker coordination.

After careful examination of its research and findings, the FCA concluded that 'overall, the market study has not found evidence of significant levels of harm that may merit the introduction of intrusive remedies'.

On the Web

You can access the FCA's press release announcing the Wholesale Insurance Broker Market Study (MS17/2) here:

<https://bit.ly/2JQN7G8>.

The Wholesale Insurance Broker Market Study: Terms of Reference (MS17/2.1) can be accessed here:

www.fca.org.uk/publication/market-studies/ms17-2-1.pdf.

The Wholesale Insurance Broker Market Study: Final Report (MS17/2.2) can be accessed here: <https://www.fca.org.uk/publication/market-studies/ms17-2-2.pdf>.



Consider this...

Read the findings of the five areas focused by the FCA in the Final Report – do you agree with the findings? How does it reflect in your organisation?



In the retail sector, renewal pricing is an important issue and the work that BIBA has been doing along with the ABI is acknowledged. The FCA carried out a thematic review (TR18/4) to better understand pricing practices in retail general insurance, focusing on home insurance.

As with any work, this considered what effect current pricing practices have on particular groups of consumers, including vulnerable consumers. Key findings were reported on 31 October 2018. Following this, the FCA launched its market study (MS18/1) into how general insurance firms price home and motor insurance policies.

The provision of insurance to vulnerable consumers

As noted in the consultation paper *Our Future Approach to Consumers* (2017), while not necessarily vulnerable, some consumers can find that they are inadvertently excluded from participating in financial services due to their specific characteristics or circumstances, or that firms actively do not wish to service them due to the perceived risk that they represent. When a consumer faces barriers accessing financial services this undermines their ability to take responsibility for their own financial security, which in turn potentially damages their longer-term wellbeing.

The *Feedback Statement: Call for Input on Access to Travel Insurance* (FS18/1), looks at the challenges for firms and consumers in providing and accessing fairly-priced cover for people with pre-existing medical conditions. The FCA wants to understand the market and consumers' journeys better and use this as an opportunity for industry, regulators and consumer groups to work together to produce meaningful change for vulnerable consumers.

The concern is that the market for travel insurance appears to be segmented between more mainstream and specialist providers. The former may have a limited appetite to insure more serious medical conditions. Specialist providers are prepared to insure consumers with these conditions, and quite often at lower premiums based on a more in-depth risk assessment. But consumers may often be unaware of the lower premiums offered by specialist providers.

On the Web

You can read the full FS18/1 here:

www.fca.org.uk/publication/feedback/fs18-01.pdf.



Data

Big Data is a priority theme to be considered in the following ways:

- why the subject is important in insurance; and
- the issues being faced and the impact of the new EU data regulation.

Insurance by its very nature is a data-hungry business. The assessment and pricing of risk depends on good data about the insured. So, it should be no surprise that we see insurers are very active in the Big Data and data-use field. The much expanded access to and ability to process that goes with Big Data has clear positives and some risks of harm.

The positives come from better assessment and pricing of risk, and also that it allows insurers to price risk on a more individual basis, rather than in sub-groups. This can not only improve risk assessment, but also can create a virtuous outcome where if we are individually assessed, we are incentivised to improve our habits (for example our driving if it can be directly observed) and this could be a good thing. We may drive more carefully if we can count the benefit of doing so in a lower premium. This doesn't work so well if we are in sub-groups whose average behaviour we can do little to influence.

General Data Protection Regulation (GDPR)

This places more emphasis than before on those processing personal data being accountable for and transparent about the lawful basis for that processing. In other words, identifying the processing and explaining it to individuals.

The notion of genuine consent is important here, principally because individuals have real choice and control; for instance, through positive opt-in rather than default mechanisms or pre-ticked boxes. Genuine consent builds trust and engagement but there are other bases on which data can be processed, beyond consent which include contract requirements and legal obligations.

GDPR also places more emphasis on the rights of individuals. They must, for example, be given more information than before about how their data are processed, be allowed access to their data and have more control about how they are used (including a new right of 'portability').

A number of principles underpin the GDPR. The more important in this context is responsibility and accountability and thus the role of governance in firms. Turning the principles into practice requires a more proactive approach on the obligations of controllers and the rights of individuals. It requires contracts to be in place when using a third-party data processor, but this does not mean that the responsibility for compliance with the GDPR can be outsourced. And finally, there is an important security principle around the protection of individuals' data.

The vast increase in the processing of data can lead to more innovation and competition in financial markets and can open the markets up to consumers. The risks are that such processing can exacerbate information asymmetries, create conflicts of interest among commercial parties involved and can increase the risk of some consumers being excluded. Generally, consumers don't understand the value of their personal data, and therefore what ownership really means.

There is, however, a subtle but important distinction between whether consumers know the value and what they value. Individuals value privacy but it is less clear what degree of privacy they expect and assume given the pace of change. Many value speed of access and expect it; the trade-off between speed and privacy may be an example of the conflict between short-term rewards and long-term goals. But if we come back to the GDPR and the theme of consent, the need for speed tends to suggest that the process of consent is viewed as tedious once the decision has been made to go ahead.



On the Web

You can read the FCA's *Business Plan 2018/19* in full here:

www.fca.org.uk/publication/business-plans/business-plan-2018-19.pdf.

C2 Principles for Businesses

The *Principles for Businesses (PRIN)* are at the heart of the regulation. They have survived the change from FSA to FCA without alteration and remain a framework of reference for much of what the FCA does. In particular, they are the foundation upon which the introduction of new, and changes to existing, rules and guidance are built. Whenever the FCA is considering improvements to the regulatory framework, it makes reference to the relevant principles that it judges apply.

Principles for Businesses (PRIN)	
Principle	Detail
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 FCA appropriately anything relating to the firm of which that regulator would reasonably expect notice.

Note: The PRA applies Principles 1 to 4, 8 and 11 only. © Financial Conduct Authority

A new rule in ICOBS(ICOBS 2.5.-1 R), deriving from the IDD, applies Principle 6 to distributors including brokers. The requirement is to act honestly, fairly and professionally in the best interests of their customers. This is known as 'the customer's best interests rule'.

D Threshold Conditions

Threshold Conditions (TCs) are the minimum standards for being, and remaining, authorised.

Table 5.1: Threshold Conditions

Location of offices	If a person carries on insurance mediation activity: where it is a body incorporated in the UK, its registered office (or if none, its head office) must be in the UK. If an individual is resident in the UK, they are to be treated as having a head office in the UK.
Effective supervision	The FCA must be satisfied that it can effectively supervise a firm, taking into account the nature/complexity of the firm's regulated activities, the complexity of any products the firm provides and the way in which the firm's business is organised. If a firm is a member of a group, the FCA must take into account whether membership is likely to prevent effective supervision and if the firm has close links with another firm. If it does have close links, the FCA must take into account the nature of the relationship and whether this is likely to prevent the firm's effective supervision.
Appropriate resources	The FCA must be satisfied that the firm has adequate resources. Adequacy of resources is not just about financial resources. The FCA also looks at whether the firm has adequate management and staff, both in terms of quantity and quality.
Suitability	The FCA must be satisfied that the firm is 'fit and proper' to be authorised. In assessing this, the FCA looks at the competence and ability of management as well as its commitment to carrying on the business with integrity and in compliance with the regulatory regime.

Table 5.1: Threshold Conditions

Business model	The FCA must be satisfied that the firm's business model is compatible, with its affairs being conducted in a sound and prudent manner, with the interests of consumers in mind and in a way that maintains the integrity of the UK financial system.
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As shown in table 5.1, the FCA defines a number of TCs:

1. **Locations of offices:** the head office must be in the UK. Of course, foreign-owned firms can be regulated but the regulated entity must have its head office in the UK, even if the parent is domiciled in the US, Bermuda or Dublin.
2. **Effective supervision (including the current Close links TC):** the simple expression 'close links' introduces a degree of 'extra-territoriality' into the regulation. What this means is that for a broker that has a foreign parent, the FCA has to be satisfied about the degree of influence exerted over the conduct of the firm's affairs by people based outside the UK.
3. **Appropriate resources:** again, a simple-looking requirement. In practice, this means that the FCA can make enquiries about and exert considerable influence over any aspect of management structure and business operations, spans of control and capital held by the regulated entity. The FSA used TC3 with much greater vigour since the demise of Lehman Brothers in 2008. This is due to a concern that, in the event of the failure of a foreign parent, there is sufficient capital and cash in the regulated business in the UK to enable it to meet its obligations. The FSA also made extensive use of Section 166 reports in this respect – see *Discipline and enforcement* on page 5/43.
4. **Suitability:** the FCA has to be satisfied with the general conduct of the firm and with the integrity of the management. While the FCA is unlikely to state publicly that an individual is unsuitable to be an approved person, it will indicate whether a given individual should apply to become one or not.
5. **Business model:** the FCA is looking to see that firms put their customers at the heart of what they do in a sound and prudent manner.

E Senior Management Arrangements, Systems and Controls (SYSC)

The **Senior Management Arrangements, Systems and Controls (SYSC)** have four main purposes:

1. To encourage the directors and senior managers of firms to take appropriate practical responsibility for their firms' arrangements on matters that are likely to be of interest to the FCA because they impinge on the FCA's functions under the **Financial Services and Markets Act 2000**.
2. To increase certainty by amplifying Principle 3, under which a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
3. To encourage firms to assign responsibility for effective and responsible organisation to specific directors and senior managers.
4. To create a common platform of organisational systems and controls requirements for all firms.

You do not have to commit the detail of SYSC to memory. However, you should be familiar with the key parts of SYSC, summarised in this section, and its rules.

Table 5.2: General organisational requirements (SYSC 4)

General requirements (SYSC 4.1)	
Organisation	A firm must have robust governance arrangements, which include a clear organisational structure with well-defined, transparent and consistent lines of responsibility; effective processes to identify, manage, monitor and report the risks it is or might be exposed to; and internal control mechanisms, including sound administrative and accounting procedures, and effective control and safeguard arrangements for information processing systems. Proportionality: the arrangements, processes and mechanisms above should be comprehensive and proportionate to the nature, scale and complexity of the risks inherent in the firm's business model and activities.
Mechanisms and procedures for a firm	A firm, taking into account the complexity of its business,: • must maintain adequate internal control mechanisms designed to secure compliance with decisions and procedures at all levels of the firm; • should maintain decision-making procedures and an organisational structure that clearly, and in a documented manner, specifies reporting lines and allocates functions and responsibilities; and • should maintain effective internal reporting and communication of information at all relevant levels, as well as effective information flows with any third party involved.
Audit committee	Depending on the nature, scale and complexity of its business, it may be appropriate for a firm to form an audit committee. This committee would typically examine management's process for ensuring the appropriateness and effectiveness of systems and controls, examine the arrangements made to ensure compliance, oversee the internal audit function (if applicable) and communicate with external auditors. It should have an appropriate number of non-executive directors and formal terms of reference.
Business continuity	Firms should take reasonable steps to ensure continuity and regularity in the performance of its regulated activities and employ appropriate and proportionate systems, resources and procedures. Firms should maintain an adequate business continuity policy (BCP) aimed at ensuring, in the case of an interruption, that any losses are limited, the preservation of essential data and functions, and the maintenance of its regulated activities. SYSC 4.1.8 prescribes the component parts of a BCP.
Regular monitoring	Firms should monitor and, on a regular basis, evaluate the adequacy and effectiveness of its systems and internal control mechanisms and take appropriate measures to address any deficiencies.
Apportionment of responsibilities: the role of the non-executive director (NED)	The role will vary – where an NED is an approved person in a body corporate, their responsibility and liability will be limited by the role they've undertaken.
Persons who effectively direct the business (SYSC 4.2)	
Senior personnel	The senior personnel of a firm must be of sufficiently good repute and experience to ensure the sound and prudent management of the firm.
Responsibility of senior personnel (SYSC 4.3)	
Responsibility of senior personnel	When allocating functions, firms must ensure that senior personnel are responsible for ensuring the firm complies with its obligations under the regulatory system. In particular, senior personnel must assess and periodically review the effectiveness of the policies and procedures in place to comply with the regulatory system, and take appropriate measures to address any deficiencies.
Written reports rule	Firms should ensure that its senior personnel receive written reports at least annually on compliance, internal audit and risk control indicating in particular whether the appropriate remedial measures have been taken in the event of any deficiencies.

Table 5.3: Employees, agents and other relevant persons (SYSC 5)

Skills, knowledge and expertise (SYSC 5.1)

Skills, knowledge and expertise	Competent employees rule: A firm must employ personnel with the skills, knowledge and expertise necessary to discharge the responsibilities allocated to them. (It is worth noting that SYSC 28 contains rules and guidance relating to the minimum knowledge and competence requirements in relation to a broking firm.) A firm's systems and controls should enable it to satisfy itself of the suitability of anyone who acts for it. This includes assessing an individual's honesty and competence. This assessment should normally be made at the point of recruitment. An individual's honesty need not normally be revisited unless something happens to make a fresh look appropriate. Any assessment of an individual's suitability should take into account the level of responsibility they will assume. The assessment will generally differ depending upon whether it takes place at the start of the individual's recruitment, at the end of the probationary period (if there is one) or subsequently. The Training and Competence (TC) sourcebook contains additional rules and guidance relating to specified retail activities undertaken by a firm. Firms carrying on activities that are not subject to TC may nevertheless wish to take TC into account in complying with the competence requirements in SYSC (see Training and Competence (TC) on page 6/9.
Segregation of functions	Firms should ensure that the performance of multiple functions by its relevant persons does not prevent those persons from discharging any particular functions soundly, honestly and professionally. Senior personnel should define arrangements concerning the segregation of duties within the firm and the prevention of conflicts of interest. The effective segregation of duties is an important element in the internal controls of a firm in the prudential context. In particular, it helps to ensure that no one individual is completely free to commit a firm's assets or incur liabilities on its behalf. Segregation can also help ensure a firm's governing body receives objective and accurate information on financial performance, the risks faced by the firm and the adequacy of its systems. A firm should normally ensure that no single individual has unrestricted authority to do all the following: initiate a transaction, bind the firm, make payments and account for it. Where this is not feasible (e.g. because the firm has a limited number of staff), the firm should ensure that adequate compensating controls are in place (e.g. frequent review of an area by relevant senior managers).
Awareness of procedures	Firms should ensure that relevant personnel are aware of the procedures for proper discharge of their responsibilities.
General	The systems and internal control mechanisms established by a firm should take into account the complexity of its business. Firms should monitor and regularly evaluate the adequacy and effectiveness of its systems, internal control mechanisms and arrangements here and take appropriate measures to address any deficiencies.

Table 5.4: Compliance, internal audit and financial crime (SYSC 6)

Compliance (SYSC 6.1)	This covers policy and procedures, monitoring and personnel and is covered in detail in the next chapter.
Internal audit (SYSC 6.2)	Firms should, where appropriate and proportionate to the scale and complexity of its business, maintain an internal audit function separate and independent from the other functions of the firm. The internal audit function should: • maintain an audit plan to examine and evaluate the adequacy and effectiveness of the firm's systems and internal control mechanisms; • issue recommendations based on the result of work carried out; • verify compliance with those recommendations; and • report appropriately.
Financial crime (SYSC 6.3)	This focuses on money laundering, which is covered in detail in the next chapter.

Table 5.5: Risk control (SYSC 7)

Risk control (SYSC 7.1)	
Risk management policies and procedures rule	Firms should maintain adequate risk management policies and procedures, including effective procedures for risk assessment. These procedures should identify the risks relating to the firm's activities, processes and systems, and where appropriate, set the level of risk tolerated by the firm.
Implementation	Firms should adopt effective processes and mechanisms to manage the risk relating to the firm's activities, processes and systems, in light of the above level of risk tolerance. Firms' boards or senior partners must approve and periodically review the strategies and policies for taking up, managing, monitoring and mitigating the firm's risk exposure, including that posed by the macro-economic environment in which it operates in relation to the status of the business cycle. In compiling the strategies, policies and procedures for identifying, taking up, managing, monitoring and mitigating the risks to which the firm is or might be exposed, firms should consider conducting reverse stress tests on its business plan. This would further senior personnel's understanding of the firm's vulnerabilities and would help them design measures to prevent or mitigate the risk of business failure. Firms should monitor the: • adequacy and effectiveness of its risk management policies and procedures; • level of compliance with the arrangements, processes and mechanisms adopted; and • adequacy and effectiveness of measures taken to address any deficiencies in them, including failures by the personnel responsible for their compliance. Firms should, where appropriate and proportionate, maintain a risk management function that operates independently and carries out the following tasks: • Implementation of the policies and procedures referred to. • Provision of reports and advice to senior personnel. Where not required to maintain an independent risk management function firms should, nevertheless, be able to demonstrate that the policies and procedures it has adopted satisfy the requirements of the rules and are consistently effective.

Table 5.6: Outsourcing (SYSC 8)**General outsourcing requirements (SYSC 8.1)**

A firm should:

- ensure it takes reasonable steps to avoid undue additional operational risk when relying on a third party for the performance of operational functions critical for the performance of regulated activities on a continuous and satisfactory basis; and
- not outsource important operational functions in such a way as to impair materially the quality of its internal control and the ability of the FCA to monitor the firm's compliance.

An operational function is regarded as critical or important if a defect or failure in its performance would materially impair a firm's continuing regulatory compliance.

The following functions are not considered as critical or important:

- The provision to the firm of advisory services including legal advice, training of personnel, billing services and the security of the firm's premises and personnel.
- The purchase of standardised services, including market information services and the provision of price feeds.
- The recording and retention of relevant telephone conversations or electronic communications.

If a firm outsources critical or important operational functions it remains fully responsible for discharging all its regulatory obligations.

Firms should exercise due skill, care and diligence when entering into, managing or terminating any arrangement for outsourcing of critical or important operational functions. Firms should, in particular, take the necessary steps to ensure that the following conditions are satisfied:

- The service provider should have the ability, capacity and any authorisation required by law to perform the outsourced functions reliably and professionally.
- The service provider must carry out the outsourced services effectively, and the firm should establish methods for assessing the standard of its performance.
- The service provider should properly supervise the outsourced functions, and adequately manage its associated risks.
- Appropriate action should be taken if it appears that the service provider may not be carrying out the functions effectively.
- The firm should retain the necessary expertise to supervise the outsourced functions and manage the associated risks, and must supervise those functions and manage those risks.
- The service provider should disclose to the firm any development that may have a material impact on its ability to carry out the outsourced functions effectively and compliantly.
- The firm should be able to terminate the arrangement for the outsourcing where necessary without detriment to the continuity and quality of its provision of services to clients.
- The service provider should co-operate with the FCA.
- The firm, its auditors and the FCA should have effective access to data related to the outsourced activities, as well as to the business premises of the service provider.
- The service provider should protect any confidential information relating to the firm and its clients.
- Both parties should maintain a contingency plan for disaster recovery and periodic testing of backup facilities where that is necessary.

Firms should notify the FCA when it intends to rely on a third party for the performance of critical operational functions.

Table 5.7: Remuneration and performance management of sales staff (SYSC 19)

Remuneration and the customer's best interests (SYSC 19F.2.2R)	Firms must not be remunerated, or remunerate or assess the performance of their employees, in a way that conflicts with their duty to comply with the customer's best interests rule (ICOBS 2.5.-1R). In particular, firms must not make any arrangements by way of remuneration, sales target or otherwise that could provide an incentive to itself or its employees to recommend a particular policy to a customer when the broker could offer a different one that would better meet the customer's needs.
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Record-keeping (SYSC 9), Conflicts of interest (SYSC 10) and Guidance on Public Interest Disclosure Act: Whistleblowing (SYSC 18) are all covered in chapter 6.

F Approved persons and the fit and proper test

An **approved person** is someone who is approved to perform a controlled function for an authorised firm or an appointed representative firm. Approved persons have to be approved by the regulator as 'fit and proper' persons and perform their controlled function in accordance with a set of standards – the Statements of Principle and Code of Practice for Approved Persons (APER). The onus is on the firm to supply information about an individual as part of the application process to satisfy the regulator that it has suitably assessed the candidate.

The Approved Persons Regime (APR) was superseded by the Senior Managers and Certification Regime (SM&CR) in late 2018 for all brokers, but approved representatives will continue to be governed by the APR.

COCON Individual and Senior Manager conduct rules	
Individual conduct rules	Detail
Rule 1	You must act with integrity.
Rule 2	You must act with due skill, care and diligence.
Rule 3	You must be open and cooperative with the FCA, the PRA and other regulators.
Rule 4	You must pay due regard to the interests of customers and treat them fairly.
Rule 5	You must observe proper standards of market conduct.
Senior manager conduct rules	Detail
SC1	You must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively.
SC2	You must take reasonable steps to ensure that the business of the firm for which you are responsible complies with the relevant requirements and standards of the regulatory system.
SC3	You must take reasonable steps to ensure that any delegation of your responsibilities is to an appropriate person and that you oversee the discharge of the delegated responsibility effectively.
SC4	You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice.

The accountable and significant-influence functions are specified in the Supervision Manual, particularly SUP 10A.4 and 10A.5. They cover a number of defined functions within regulated firms such as director, non-executive director or chief executive (see table at SUP 10A.4.4). The significant-influence function, in relation to the carrying on of a regulated activity by a firm, means a function that is likely to enable the person responsible for its performance to exercise a significant influence on the conduct of the firm's affairs in relation to the activity.

An approved person cannot carry out a controlled function unless they have first been approved by the FCA as fit and proper to carry out that function. The conduct of an approved person is measured against the Statement of Principles.

Insurance broking firms tend to have many people with the title 'director'. The approved persons regime (APER) in the context of broking only applies to those who actually direct the company's affairs (i.e. have a significant influence), which means senior staff with extensive management authority or, in smaller firms, the owners.

An important feature of being an approved person is that this person can face the full might of the FCA's sanctions, which include enforcement actions, fines and imprisonment upon conviction. Being an approved person places personal responsibility on the individual.

One aspect of FCA activity has been with respect to the global brokers with foreign parentage. Where the FCA believes that executives based outside the UK are exercising a controlled function, they have sought to bring these executives into APER. Not all such executives wish to become approved persons (and the FCA has no power to compel a foreign-based executive to become one). They may feel that the regime under the FCA is too onerous. Or they may have legitimate concerns over a conflict of interest between, for example, the US Securities and Exchange Commission (SEC) rules and the UK FCA, or their fiduciary duties to shareholders outside the UK and their obligations under UK regulation.

The result has been that some firms have had to change their governance arrangements so that there is sufficient 'distance' between the regulated entity in the UK and the overseas senior executive. Others have agreed that overseas senior executives become approved persons. The key measure is whether the overseas senior executive is exercising significant influence over the affairs of the UK-regulated firm on a regular basis.

F1 Code of Practice for approved persons

Approved persons should be familiar with the full requirements of, and must abide by, the APER.

The Code of Practice, issued under s.64 of the Financial Services and Markets Act 2000, does not set out positive aspects of conduct but instead sets out descriptions of conduct which, in the FCA's opinion, do not comply with the relevant Statements of Principle.

The code also sets out certain factors which, in the opinion of the FCA, are to be taken into account in determining whether an approved person's conduct complies with a particular Statement of Principle.

An approved person will only be in breach of a Statement of Principle where they are personally culpable. Personal culpability arises where an approved person's conduct was deliberate, or where the approved person's standard of conduct was below that which would be reasonable in all the circumstances.

To avoid doubt, the Statements of Principles do not extend the duties of approved persons beyond those which the firm owes in its dealings with customers or others.

The Code of Practice for approved persons is not exhaustive in its descriptions of the kind of conduct that may contravene the Statements of Principles. The purpose of the Code is to help determine whether or not a person's conduct complies with a Statement of Principle. The Code may be supplemented from time to time and the FCA will amend the Code if there is a risk that unacceptable practice may become prevalent. This is to make clear what conduct falls below the standards expected of approved persons by the Statements of Principle.

In applying Statements of Principles 5 to 7, the nature, scale and complexity of the business under management, and the role and responsibility of the individual performing a significant influence function within the firm, will be relevant in assessing whether an approved person's conduct was reasonable. For example, the smaller and less complex the business, the less detailed and extensive the systems of control need to be.

The FCA will only be of the opinion that an individual performing a significant influence function may have breached Statements of Principles 5 to 7 if their conduct was below the standard which would be reasonable in all the circumstances.

In determining whether or not the conduct of an approved person performing a significant influence function complies with Statements of Principles 5 to 7, the following are factors which, in the opinion of the FCA, are to be taken into account:

Has an approved person complied with SOP 5–7?				
Did they exercise reasonable care when considering the information available to them?	Did they reach a reasonable conclusion and act on it?	What is the nature, scale and complexity of the firm's business?	What is the person's role and responsibility as an approved person performing a significant influence function?	What regulatory concerns, if any, have arisen in the business under their control?

Amongst other requirements, the Code of Practice provides that:

- Individuals should not continue to undertake a controlled function having failed to meet the standards of knowledge and skill set out in the Training and Competence sourcebook.
- In organising business for which the individual performs a significant influence function, the individual should bear in mind the risks the business is prepared to take.
- The individual should consider reviewing each area of the business for which they are responsible to ensure that it is clearly assigned to a particular individuals.
- The organisation of the business and the responsibility of those within it should be clearly defined.
- If an individual's performance is unsatisfactory, then the firm should carefully review whether to allow this individual to continue in their position.
- Where the individual is not an expert in a business area, the firm should consider whether the individual or those that they work with have the necessary expertise.
- When delegating a task, there should be reasonable grounds for believing the delegate has the competence, knowledge, skill and time to address the issue.

On the Web

Code of Practice for Approved Persons (APER):

fshandbook.info/FS/html/handbook/APER.



F2 Examples of non-compliant behaviours

Statement of Principle 1

Deliberately misleading (or attempting to mislead) by act or omission, a client or their firm or the FCA by, for example, falsifying documents or providing false or inaccurate documentation or information, including details of training, qualifications, past employment record or experience; destroying documents (including false documentation), or tapes or their contents, relevant to misleading (or attempting to mislead) a client, the firm or the FCA.

Statement of Principle 2

Failing to inform a client of their obligation to disclose material information in circumstances where they were aware, or ought to have been aware, of such information, and of the fact that they should provide it.

Statement of Principle 3

An approved person must observe proper standards of market conduct in carrying out their accountable functions. Therefore, any action that would bring the market into disrepute is in breach of this Principle.

Statement of Principle 4

Failing to report promptly, in accordance with their firm's internal procedures, information which it would be reasonable to assume would be of material significance to the FCA, whether in response to questions or otherwise.

Statement of Principle 5

Failing to take reasonable steps to apportion responsibilities for all areas of the business under the approved person's control and failing to take reasonable steps to apportion responsibilities clearly among those to whom responsibilities have been delegated.

This could happen, for example, by implementing confusing or uncertain reporting lines, implementing confusing or uncertain authorisation levels and implementing confusing or uncertain job descriptions and responsibilities.

Statement of Principle 6

Failing to exercise due skill, care and diligence by, for example, poor exercise of management oversight of complaints in a reckless or negligent fashion.

Statement of Principle 7

Allowing the firm or division of the firm for which the approved person is responsible to operate in clear breach of the regulation by, for example, failing to observe the independence of the compliance function or allowing poor practice with respect to the fair treatment of customers.

F3 Fit and proper test

The FCA will have regard to a number of factors when assessing the **fitness and propriety** of a person to perform a particular controlled function. These are set out in the FIT sourcebook of the FCA Handbook.

The most important considerations will be the person's:

- honesty, integrity and reputation;
- competency and capability; and
- financial soundness.

In assessing fitness and propriety, the FCA will also take account of the activities of the firm for which the controlled function is to be performed, the regulatory permission(s) held by that firm and the markets within which it operates.

The FCA will not usually require the candidate to supply a statement of assets or liabilities. The fact that a person may be of limited financial means will not, in itself, affect their suitability to perform a controlled function.

F4 Senior Managers and Certification Regime (SM&CR)

After the financial crisis, Parliament recommended that the regulator develop a new accountability system to replace the APR that is more focused on senior managers and individual responsibility. This led to a new Senior Managers and Certification Regime (SM&CR) which was applied to banks, building societies, credit unions and PRA-designated investment firms from March 2016.

From 10 December 2018, the SM&CR has been in effect for insurers, thereby replacing the previous Senior Insurance Managers Regime (SIMR). It also applies to brokers/intermediaries and replaces the APR from 9 December 2019.

This is a key part of the FCA's Culture & Governance Priority, and its overarching aim is to reduce harm to consumers and strengthen market integrity by creating a system that enables firms and the regulator to hold people to account. As part of this, the SM&CR aims to:

- encourage staff to take personal responsibility for their actions;
- improve conduct at all levels; and
- make sure firms and staff clearly understand and can demonstrate who does what.

Many different types of firm are in scope and the FCA does not think it appropriate to take precisely the same approach as it did for the banks etc. While wanting consistent principles it also wants the regime to be proportionate and flexible enough to accommodate firms different business models and governance structures.

The tools and principles from the banking regime will therefore be tailored to reflect the different risks, impact and complexity of firms now to be subject to the extension. However, there are some requirements where there is no flexibility on application because they are stipulated in the relevant legislation.

The proposal is to apply a baseline of requirements to every firm, known as the 'core regime'. This means that the three main elements of the SM&CR will apply to every firm: the Senior Managers Regime, Certification Regime and Conduct Rules.

F4A Senior Managers Regime

This focuses on the most senior people in the firm. The rules will define which roles are Senior Management Functions (SMFs) depending on the type of firm involved. Anyone who holds a SMF needs to be approved before they start their role, the same as under the APR. Firms also need to make sure that senior managers are suitable to do their jobs.

Every senior manager will need to have a Statement of Responsibilities (SoRs) document that says what they are responsible and accountable for. Firms need to provide this to the FCA when a senior manager applies to be approved, and whenever there is a major change to their responsibilities.

Every senior manager will have a duty of responsibility which means if something goes wrong in an area that they are responsible for, the FCA will consider whether the person took 'reasonable steps' to stop this from happening.

Firms will need to give their Senior Managers certain new responsibilities ('Prescribed Responsibilities'). This is to make sure there is a Senior Manager accountable for the SM&CR and key conduct and prudential risks – more responsibilities will apply to bigger firms.

F4B Certification Regime

This covers people who are not senior managers, but whose jobs mean they can have a big impact on customers, markets or the firm. These roles will be specified in the final new rules. The FCA will not approve such individuals formally but firms will need to check and confirm ('certify') that they are suitable to do their job at least once a year.

Refer to

For an explanation of CASS, refer to [Client Assets Sourcebook \(CASS\)](#) on page 5/41

The FCA Handbook will set out all of the roles that are Certification Functions. For brokers they are: significant management functions, Client Assets Sourcebook (CASS) oversight function, client dealing function, and anyone who supervises or manages anyone performing one of these functions.

F4C Conduct Rules

These are basic rules that will apply to almost everyone who works in financial services. The Conduct Rules are about improving the behaviour of all staff and there will be two tiers. The first is a general set of rules that applies to most 'technical' employees in a firm (but not receptionists, postroom staff, invoice processing and other non-core employees in a typical broking firm).

First Tier – Individual Conduct Rules	
1.	You must act with integrity.
2.	You must act with due care, skill and diligence.
3.	You must be open and cooperative with the FCA, the PRA and other regulators.
4.	You must pay due regard to the interests of customers and treat them fairly.
5.	You must observe proper standards of market conduct.

Second Tier – Senior Manager Conduct Rules

SC 1.	You must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively.
SC 2.	You must take reasonable steps to ensure that the business of the firm for which you are responsible complies with the relevant requirements and standards of the regulatory system.
SC 3.	You must take reasonable steps to ensure that any delegation of your responsibilities is to an appropriate person and that you oversee the discharge of the delegated responsibility effectively.
SC 4.	You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice.

The proposal is to apply the Conduct Rules to a firm's regulated and unregulated financial services activities (including any related ancillary activities). For example, an activity carried on in connection with a regulated activity. This is narrower than the requirements under the banking regime, where the rules apply to everything someone does on behalf of a banking firm, whether it is regulated or unregulated or linked to financial services.

The FCA believes the narrower approach is proportionate; equally it has not limited the application to only cover an employee's role in relation to the regulated activities of a firm as it considers this too narrow.

Certain extra requirements will only apply to the largest and most complex firms (approximately 350 'enhanced' firms). Six objective criteria will be used to identify enhanced firms that the FCA believes are representative of size and complexity.

These firms will need to have responsibilities maps, handover procedures and will need to make sure that there is a senior manager responsible for every area of their firm (overall responsibility).

F5 Transition between APR and SM&CR

In December 2017 the FCA consulted on the transitional arrangements, via CP17/40. Three different types of firm have been identified and all brokers will be categorised as core firms. The basic proposal is to automatically convert most of the approved persons at core firms into the corresponding new SMFs under SM&CR.

Enhanced firms will need to submit a conversion notification (Form K) and accompanying documents. All firms will be obliged to provide training in how the new rules apply to their people.

The APR will remain in force for appointed representatives.

G Prudential Standards

The main purpose of the Prudential Standards is to implement the **Insurance Mediation Directive 2002/92/EC (IMD)**, to state who can be responsible for insurance mediation activities. The IMD has been superseded by the **Insurance Distribution Directive (IDD)** from 1 October 2018.

The other key rules are:

Table 5.8: Prudential Standards

Rule	Rubric
MIPRU 3.2 Professional indemnity insurance	A firm must take out and maintain professional indemnity insurance that is at least equal to the requirements of this section from a qualifying insurer.
MIPRU 3.2.4 Professional indemnity terms	The contract of professional indemnity insurance must incorporate terms which make provision for: 1. cover in respect of claims for which a firm may be liable as a result of the conduct of itself, its employees and its appointed representatives (acting within the scope of their appointment); 2. the minimum limits of indemnity per year set out in this section; 3. an excess as set out in this section; 4. appropriate cover in respect of legal defence costs; 5. continuous cover in respect of claims arising from work carried out from the date on which the firm was given permission for the insurance mediation; and 6. cover in respect of Ombudsman awards made against the firm.
MIPRU 3.2.7/3.2.7A G Professional indemnity insurance (PII) limits	If the firm is an insurance intermediary, then the minimum limits of indemnity are: 1. for a single claim, €1,120,200 (€1,250,000 from 1 October 2018); and 2. in aggregate, €1,680,300 (€1,850,000 from 1 October 2018) or, if higher, 10% of annual income up to £30m. These limits are periodically reviewed and amended. Article 10 (7) of the IDD requires the European Insurance and Occupational Pensions Authority (EIOPA) to review the limits of indemnity every five years, to take into account changes in the European Index of Consumer Prices and to develop draft regulatory technical standards to adapt the base amount in euro (€) by the percentage change in that index. On 1 February 2018 it issued a consultation document accordingly that recommended a revision in the limits to €1,300,370 and in aggregate, €1,924,550. At the end of July, it was confirmed that minimum PII limits under IDD had increased to the recommended revised limits. The minimum limits will be reviewed again by EIOPA in five years' time.
MIPRU 3.2.11 and 3.2.12 Professional indemnity excess	For a firm which does not hold client money or other client assets, the excess must not be more than the higher of: 1. £2,500; and 2. 1.5% of annual income. For a firm which holds client money or other client assets, the excess must not be more than the higher of: 1. £5,000; and 2. 3% of annual income.
Note	MIPRU 3.2.14 states that if a broker takes a higher excess, it will need to hold more capital than specified in MIPRU4 below.
MIPRU 4.2.11 Capital resources requirement: mediation activity only	1. If a firm carrying on insurance mediation activity or home finance mediation activity (and no other regulated activity) does not hold client money or other client assets in relation to these activities, its capital resources requirement is the higher of: a. £5,000; and b. 2.5% of the annual income from its insurance mediation activity or home finance mediation activity (or both). 1. If a firm carrying on insurance mediation activity or home finance mediation activity (and no other regulated activity) holds client money or other client assets in relation to these activities, its capital resources requirement is the higher of: a. £10,000; and b. 5% of the annual income from its insurance mediation activity or home finance mediation activity (or both).

Table 5.8: Prudential Standards

MIPRU 5.2 Use of intermediaries	A firm must not use, or propose to use, the services of another person consisting of: 1. insurance distribution; or a. reinsurance distribution; 1. insurance distribution activity; or 1. home finance mediation activity.
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G1 Insurance Distribution Directive

The **Insurance Distribution Directive 2016/97/EC (IDD)** came into force on 22 February 2016 replacing the **Insurance Mediation Directive 2002/92/EC (IMD)** and Member States originally had until 23 February 2018 to transpose it into their own legislation. The requirements have applied to firms since 1 October 2018.

This is an overview of the changes taking place. More detailed information is provided aligned to the relevant FCA Handbook areas concerned in the sections where they are covered in this study text. Other Handbook material will be aligned with the new terms but these are largely administrative and do not reflect any change in policy. The modules affected are: General Provisions (GEN), Fees Manual (FEES), Client Assets Sourcebook (CASS); and Compensation sourcebook (COMP).

It aims to enhance consumer protection when buying insurance including general insurance, life insurance and insurance-based investment products (IBIPs), and to support competition between insurance distributors by creating a level playing field. Like the IMD, the IDD covers the authorisation, passporting arrangements and regulatory requirements for insurance and reinsurance intermediaries. However, the application of the IDD is wider, covering organisational and conduct of business requirements for insurance and reinsurance undertakings. The IDD also introduces requirements in new areas, including product oversight and governance, and enhanced conduct rules for IBIPs.

G1A Extension of scope

Where the existing IMD applies to the regulation of insurance intermediaries, the new IDD applies to all sellers of insurance products (referred to as 'distributors') giving it coverage of 98% of the (EU) market, compared to 48% by the IMD 'distributors'. This means that it applies to all sellers of insurance products, including insurers that sell directly to customers (albeit in the UK the ICOBS rules already apply).

The IDD has introduced a new category of intermediary, ancillary insurance intermediaries, where a somewhat lighter touch regime will apply subject to certain conditions; chiefly that insurance distribution takes place for specific products as an adjunct to the firm's primary function. (See *Managing third parties* on page 6/20.)

It is worth noting that the Directive specifies the following:



'This Directive should apply to persons whose activity consists of the provision of information on one or more contracts of insurance in response to criteria selected by the customer, whether via a website or other media, or the provision of a ranking of insurance products or a discount on the price of an insurance contract when the customer is able to directly or indirectly conclude an insurance contract at the end of the process.'

Due to this clause, price comparison websites (aggregators) are now within scope.

The IDD also includes exceptions to what should be considered to constitute insurance distribution, building on those established in the IMD. Points (a) and (b) were established in the IMD, with the IDD adding (c) and (d).



1. the provision of information on an incidental basis in the context of another professional activity where:
 - a. the provider does not take any additional steps to assist in concluding or performing an insurance contract;
 - b. the purpose of that activity is not to assist the customer in concluding or performing a reinsurance contract;
2. the management of claims of an insurance undertaking or of a reinsurance undertaking on a professional basis, and loss adjusting and expert appraisal of claims;
3. the mere provision of data and information on potential policyholders to insurance intermediaries, reinsurance intermediaries, insurance undertakings or reinsurance undertakings where the provider does not take any additional steps to assist in the conclusion of an insurance or reinsurance contract;
4. the mere provision of information about insurance or reinsurance products, an insurance intermediary, a reinsurance intermediary, an insurance undertaking or a reinsurance undertaking to potential policyholders where the provider does not take any additional steps to assist in the conclusion of an insurance or reinsurance contract.

G1B Freedom to provide services and freedom of establishment

The new regime will simplify the procedure for cross-border entry to insurance markets across the EU in a number of ways. Member States will be expected to establish a 'single information point' providing public access to their registers for insurance, reinsurance and ancillary intermediaries. In return, EU regulator EIOPA will establish a website coordinating each of their individual information points.

Any Member State which possesses additional 'general good' type rules will need to ensure that these are made publicly available. This principle, which is based on EU case law and was developed first in the context of free movement of goods and services, allows host states to impose additional regulatory measures if those measures serve a general good.

Although this is no formal definition, the Court of Justice of the European Union (CJEU) has acknowledged that areas including (but not limited to) consumer protection, social order, prevention of fraud and the protection of intellectual property could fall within the scope of the interest of the general good. EIOPA will publish links to the websites of the competent authorities of Member States where information on general good rules is published, and will review their use in the context of the proper functioning of the market.

The current regime does not include provisions on the split of jurisdiction between home and host Member State regulators. Under the new regime, any breaches of the Directive will need to be referred back to the competent authority of the home Member State in the first instance. There will also be clear areas in which the new regime will grant jurisdiction to the host Member State regulator.

The FCA currently has the authority to take enforcement action against EEA firms passporting into the UK and claims jurisdiction over all activities of UK firms passporting into other EEA states. The home Member State may agree that another Member State will act as home Member State if the distributor's primary place of business is located there.

G1C Organisation and professional requirements

The new regime requires stricter and more specific professional requirements. EU Member States will have to establish and publish mechanisms to effectively control and assess the knowledge and competence of insurance and reinsurance brokers and (re)insurer employees. This should be based on at least 15 hours of CPD per year. Home Member States may require that the successful completion of the training and development requirements is proven by obtaining a certificate but the FCA is not introducing mandatory qualifications to the UK.

The IDD sets minimum professional indemnity insurance requirements for intermediaries of at least €1.25m per claim or €1.85m in aggregate, unless such insurance or comparable guarantee is already provided by an insurance or other undertaking on whose behalf the broker is acting. This is currently €1m or €1.5m under the IMD but the limits imposed by FSA/FCA are significantly higher for most firms. Ancillary insurance intermediaries will also be required to hold professional indemnity insurance.

G1D Complaints handling and out-of-court redress

Article 14 of the IDD requires insurance and reinsurance distributors to have a complaints process for all types of insurance transaction involving retail and/or a commercial customers; and Article 15 requires Member States to have 'adequate and effective, impartial and independent out-of-court complaint and redress procedures'.

FCA will address this by relying on the existing Dispute Resolution: Complaints (DISP) rules with amendments where necessary: a new rule will extend the remit to all insurance and reinsurance distributors when carrying on distribution activities. There will also be an amendment to include complaints about business carried on by UK firms from a branch in another EEA state.

The Financial Ombudsman Service (FOS) will continue to handle complaints arising from business carried on from an establishment in the UK by incoming EEA firms. UK (re)insurers and brokers conducting business via EEA branches will be required to provide access to an Alternative Dispute Resolution (ADR) entity in the EEA state.

There will be no extension to the scope of the jurisdiction of the FOS to consider complaints from wider commercial customers as a result of the IDD, but the FCA is considering whether the definition of an eligible complainant (which currently includes micro-enterprises) should be extended to include some larger SMEs and will keep the position under review.

G1E Information requirements and conduct of business rules

The new regime will introduce two general principles, providing that:

- insurance distributors must 'always act honestly, fairly and professionally in accordance with the best interests of customers'; and
- all information must be 'fair, clear and not misleading'.

These two principles are more or less the same as in the FCA's existing Principles for Businesses. Some have commented that this may be the beginning of EU-level principles-based regulation.

There are also detailed requirements about the information that insurance distributors must disclose to customers before the conclusion of an insurance contract including, but not limited to, identity, address and registration detail. The requirements are different depending on whether the business is an insurer, intermediary or ancillary insurance intermediary.

Provisions that required insurance distributors to provide detailed information on their remuneration have been removed and replaced by less onerous requirements. This issue was considered by the UK House of Commons European Scrutiny Committee in a report published in December 2014.

The report noted that the Government had not seen any justification, in the context of non-investment insurance products, in requiring mandatory disclosure by distributors of granular information on the level and structure of commission received and that the European Commission's original proposals would overload customers with information and would probably not be understood.

G1F Product oversight and governance

New guidance will help firms understand the IDD requirements to provide clarity on issues such as:

- cases where distributors have a role in product manufacture;
- target market assessment;
- product testing; and
- ongoing product reviews.

Existing Responsibilities of Providers and Distributors for the Fair Treatment of Customers (RPPD) guidance and the IDD product governance provisions are similar, but there are some differences. Removal of relevant existing guidance could lead to consumer harm, so the FCA proposes to retain it by inserting it into the Product Intervention and Product Governance Sourcebook (PROD).

For example, guidance will be included that, in monitoring and reviewing products after sale, manufacturer firms should consider the need for communication of contractual breakpoints to customers and the need for fair and prompt claims handling.

The IDD and Markets in Financial Instruments Directive II (MiFID II) product governance requirements are similar, but MiFID II requirements go further in a number of areas. Requirements will be based on the additional MiFID II provisions, adapted where necessary for firms conducting insurance business. This will cover areas such as:

- product design considerations in assessing product charging structure and value for money;
- ensuring manufacturers make available to any distributor information regarding the target market assessment undertaken; and
- information that distributors should seek from manufacturers.

G1G Cross-selling and bundled products

Among other things, the new regime provides that when an insurance product is offered together with another service, in a package or as a condition for the same agreement or package, the insurance distributor must inform the customer whether it is possible to buy the different components separately. If so, it must provide an adequate description of the different components of the agreement or package as well as separate evidence of the costs and charges of each component. These new provisions tie in with the FCA's recent market study on 'add-ons' (see [bit.ly/2znVpjA](https://www.bit.ly/2znVpjA)), so these changes will have less of an impact in the UK.

G1H Registration

Article 3 of the IDD contains provisions relating to the registration of intermediaries. There is no requirement for firms that are already registered under the IMD to re-register. The authorisation process will remain substantively the same, with the exception that the FCA will now be required to deal with a complete application within three months.

H Insurance Conduct of Business (ICOBS)

Insurance Conduct of Business (ICOBS) is part of the FCA's *Business Standards*.

Refer to

Refer to chapter 3 of M81, which has more depth on ICOBS. You can find this on RevisionMate.

The ICOBS rules plus guidance apply to any firm or individual providing general insurance; for example, insurers, third-party processors, service companies and managing agents, and firms providing 'insurance mediation services'. Chapter 3 of M81 discusses ICOBS in depth, and can be accessed via RevisionMate.

There are many similarities between the new and existing rules but the overlap is not complete. For example, Principle 6 (PRIN 2.1.1 R) currently requires a firm to 'pay due regard' to its customers' interests, whereas the IDD requires that firms act in their customers' best interests. In ICOBS, 'customer' is defined as being a policyholder or prospective policyholder and it is worth noting that this definition will apply to the new customer's best interests rule.

H1 IDD General Principles - Amendments to ICOBS 2

The IDD introduces the following overarching requirements, that apply in a similar way to the Principles for Businesses:

- Distributors must act honestly, fairly and professionally in the best interests of their customers.
- Distributors must communicate in a way which is clear, fair and not misleading, including ensuring that marketing materials are clearly identifiable as such.
- Remuneration of a distributor or its employees, and performance management of employees, must not conflict with the duty to act in the customer's best interests.

The existing rules and the requirements of the IDD are very similar but there are differences that require amendments to the Handbook:

- including a new rule ICOBS 2.5 requiring insurance distributors to act honestly, fairly and professionally in the best interests of their customers ('the customer's best interests rule');
- amending the current ICOBS rules on communications and financial promotions to require that all marketing communications be clearly identifiable as such; and
- including a new rule in SYSC to prohibit remuneration and performance management practices that would conflict with the customer's best interests rule.

Wholesale brokers

Currently ICOBS applies to brokers who are in contact with the customer and not to other intermediaries in the distribution chain. The conduct of business requirements in the IMD primarily focus on information disclosure, but the IDD contains requirements relevant to all intermediaries carrying out insurance distribution activities, regardless of contact with the end customer. So FCA will amend the application of ICOBS accordingly.

This approach is in line with the purpose of the IDD to ensure that consumer protections should be the same, regardless of the differing distribution channels through which insurance contracts are offered.

The application of the new rules to wholesale firms for the sale of individual policies will vary depending on the circumstances and the activities the firm performs. A wholesale broker that concludes a contract placed with them by a retail broker will need to act in accordance with the customer's best interests rule. This may involve placing some reliance on information provided by other firms in the distribution chain.

The rules apply to activities which wholesalers carry out beyond the sale of an individual policy and the FCA advises they should consider the requirements of the new rules in SYSC 19F (see below) when determining their remuneration structures.

This will apply equally to a price comparison website that proposes a contract but directs a customer to another broker or insurer. Consideration should also be given to the new rules proposed in regard to product oversight and governance.



SYSC 19F.2.2R(1) Remuneration and the customer's best interests

1. Insurance distributors must not:

- be remunerated; or
- remunerate or assess the performance of their employees;

in a way that conflicts with their duty to comply with the customer's best interests rule.

2. In particular, an insurance distributor must not make any arrangements by way of remuneration, sales target or otherwise that could provide an incentive to itself or its employees to recommend a particular contract of insurance to a customer when the insurance distributor could offer a different insurance contract which would better meet the customer's needs.

H1A Pre-contract Disclosures - Amendments to ICOBS 4

The information that firms must provide about themselves and their services needs to be updated to reflect the requirements of the IDD. In line with the new customer's best interests rule, it is important that firms consider how they make information meaningful to customers. Firms should make sure that the information is provided at an appropriate time and through the right channels.

The FCA's work on Smarter Consumer Communications has shown that different people engage with information in different ways, and that information alone is not always enough to empower consumers to make informed choices.

Firms' communication is vital to help consumers make decisions but it is only effective when consumers pay attention to it, have the capacity to interpret it and are willing to incorporate it in their decision-making process.

H1B General pre-contract disclosures

The IDD builds on the existing pre-contract information requirements currently in place. The new requirements are as follows:

- The pre-contract disclosure regime now applies to insurers.
- Firms must state what type of firm they are (broker or insurer).
- Firms must state whether they provide a personal recommendation.
- Brokers must state whether they are acting on behalf of the customer or the insurance undertaking.

It is particularly relevant to make clear whether or not advice is being provided. Customers do not always understand the difference between information and advice so a well-worded and timely disclosure can help the customer understand the scope (and limitations) of the service the broker is providing.

It is recognised that some brokers may act for both the insurer and the customer at different times, e.g. for the customer when sourcing a suitable policy and for the insurer when receiving a claim notification.

However, the FCA does not believe that this will be difficult for firms to explain or for customers to understand. Firms should ensure they make all the required disclosures in a way which is likely to be useful to the customer. This can also help avoid customers being overloaded with information.

H1C Disclosures relating to conflicts of interest and transparency

The IDD requires changes to the existing disclosures covering conflicts of interest for a broker. It introduces the following new requirements to disclose information concerning the firm's remuneration (insurers and brokers):

- Brokers must make disclosures about shareholding links between the intermediary and any insurers.
- Where brokers do not provide advice on the basis of a fair and personal analysis of the market, they must disclose the names of insurers with whom they may place business.
- Brokers must disclose the nature of their remuneration in relation to the insurance contract and whether they work on the basis of a fee, commission or some other form of remuneration (or a combination thereof).
- Insurers must disclose the nature of the remuneration paid to their employees.
- All firms must disclose fees payable by the customer in cash terms. This includes fees which may become payable later such as for mid-term adjustments or early cancellation.

These requirements apply to both advised and non-advised sales. Brokers who conduct non-advised sales will need to disclose the names of the insurers with whom they may place business.

Firms do not need to make disclosures about the remuneration of other firms in the distribution chain.

The FCA intention is that the disclosure rules apply to remuneration, including non-monetary benefits, which is received either specifically for the sale of the insurance contract or for achieving a target to which the sale of the insurance contract contributes or may contribute.

H1D Disclosure of remuneration arrangements

The IDD requires brokers to disclose the nature and basis of the remuneration they receive. Insurers must likewise disclose the nature of the remuneration paid to their employees. Where the remuneration is in the form of a fee paid by the customer, the amount of that fee must be disclosed. Firms are permitted to disclose the method of calculation instead of the actual amount, but only if the amount cannot be calculated at the time.

The terms 'nature' or 'basis' are both capable of being applied differently by different firms so guidance in ICOBS will ensure there is consistency:

- **Nature** requires firms to disclose the type of remuneration they will receive or pay – this could be a basic commission, bonus, profit share or other financial incentive.
- **Basis** requires firms to disclose the source of the remuneration they receive.

Firms should disclose information about remuneration which has a direct connection to the insurance contract being sold. This includes bonuses for hitting a sales target (where the specific contract sold will count directly towards that target) but may not include measures such as rewards for adherence to quality standards.

Firms should ensure they disclose the information in a way that is useful to their customers in showing the relationship between firms in the distribution chain, and in highlighting potential conflicts of interest.

Current requirements in ICOBS 4.4 for brokers to disclose the amount of commission they receive on request by the commercial customer and guidance on a similar obligation in regard to retail customers are unaffected by the IDD and will not be amended.

ICOBS 4.3 currently requires firms to disclose the amount of any fees payable by the customer. The definition of 'fee' will be aligned with the IDD definition. Firms should consider the following points when implementing these requirements:

- Firms must provide the exact amount of the fee, or the method of calculation if the exact amount cannot be provided. Merely providing a range of possible fees (for example, 'up to £50') without more information is not compliant.
- It is only permissible to provide the method of calculation if the exact amount cannot be calculated at the time. If the exact amount is known it must be disclosed. Firms should bear in mind the requirement to communicate in a manner which is clear, fair and not misleading. This means that the 'method of calculation' should be expressed in a way that the consumer can understand, and by reference to information available to them. In practice, the FCA believes that if firms can set out the method of calculation adequately, they will also be able to state the actual amount of the fee.
- The requirements of the IDD apply to all post-contract fees that the customer may incur during the life of the policy such as administration fees for mid-term adjustments and early cancellation.

H1E Means of providing information

The IDD sets out new provisions on how information must be provided to customers. In summary, the requirements are:

- information must be clear and accessible, on paper and provided free of charge;
- firms can provide information through the means of a durable medium other than paper (such as by email) where it is appropriate and the customer has chosen it; and
- firms can provide information through a website where certain conditions are met and the customer has chosen it.

Where firms wish to provide the information through a durable medium other than paper, the FCA expects them to present the customer with a choice between the available options, rather than simply giving one option and asking for their consent.

H1F Definition of durable medium

The notion of durable medium is embedded in several pieces of European legislation which require that a firm must provide certain information to a client in writing, either on paper or in another durable medium. The core definition of durable medium is consistent across the legislation. The exception has been the IMD, however, the IDD brings the definition into line with other Directives so the definition will be brought in line with it.

H2 Amendments to ICOBS 5 – Sales demands and needs

All firms are required to identify their customers' insurance demands and needs, and ensure that insurance contracts proposed are consistent with them. Where a firm provides advice, it must explain why a contract best meets the customer's needs. Article 20 of the IDD also contains provisions relating to product information and the provision of an Insurance Product Information Document (IPID) by the product 'manufacturer'.

The IDD makes it clear that firms need to specify the customer's insurance demands and needs based on information obtained by the firm from the customer. This clarifies that firms must take an active role in identifying the customer's demands and needs (through asking questions).

An additional provision that ‘any contract proposed shall be consistent with the customer’s insurance demands and needs’ means firms must only offer contracts that meet the customers’ demands and needs. Firms need to take two steps:

1. Identify the customer’s demands and needs, and match them to the available products.
2. State the customer’s demands and needs to assist them in making an informed decision.

H2A Non-advised sales

There is a need to retain a clear distinction between advised and non-advised sales. In relation to non-advised retail sales, firms are not expected to carry out a detailed investigation of the customer’s circumstances but they should identify their essential demands and needs, and ensure that the contracts proposed provide cover that meets them.

The purpose of the demands and needs requirement is ‘to assist the customer in making an informed decision’. Firms should therefore identify demands and needs early on in the sales process, and take this into account when designing their customer journeys.

Guidance has been updated to make it clear that firms must ensure that they identify and specify the demands and needs of the particular customer.

For example, it would not be appropriate to provide a generic statement of demands and needs where the firm has not first taken steps to identify the demands and needs of the actual customer.

However, generic statements of demands and needs may be appropriate if the firm has narrowed the product options it offers to only those where the customer’s demands and needs match those in the statement.

H2B Advised sales

The demands and needs requirement has been tightened. Firms that provide a personal recommendation must provide a personalised explanation why the proposed product best meets the customer’s insurance demands and needs. Firms must match the customer’s demands and needs to the available products, and set out a personalised explanation of why the product proposed best meets those needs.

To comply with this and the requirement to act in the customer’s best interests, if the firm does not offer a product which meets the customer’s needs it should say so.

The IDD does not set out a prescriptive format for the personalised recommendation. Firms may provide this in any format consistent with the IDD, provided it clearly explains to the customer the recommendation being made and why the product best meets their needs.

Equally, there is nothing that specifically requires the firm to set out which needs have not been met. However, firms are required to identify and specify the customer’s demands and needs, and to explain why the product proposed is the best match for those needs. These requirements will, in effect, lead to any unmet needs being highlighted.

H2C General

Demands and needs requirements already apply to renewals and the new provisions will not be significantly different. Firms should already be identifying and specifying a customer’s demands and needs, so they already have the information with which to satisfy themselves that a contract is consistent with those needs.

The requirements apply to price comparison websites in the same way. The identification of customer demands and needs, and the matching of these with products, needs to take place before conclusion of the contract. Price comparison websites are well positioned to ask their customers questions and identify their needs through the answers given.

The new rules are generally compatible with online selling, as long as the right questions are asked. It may be that sales conducted through non-interactive means, such as by generic mailshot, are less likely to be compatible with the minimum requirement. If a firm cannot adequately identify the customer’s needs then it is unlikely that they will be able to ensure that products proposed are consistent with the customer’s demands and needs.

H3 Amendments to ICOBS 6A – Sales practices

H3A Cross-selling

New requirements apply to the cross-selling of insurance products where an insurance policy is sold in connection with, or alongside, other goods or services as part of a package or the same agreement. 'Ancillary' has a broad meaning and these requirements include all instances where insurance is sold to complement other goods or services.

In packages where insurance is the primary product, information must be given on whether the different components of the package can be bought separately. The distributor must also provide an adequate description of the component products, explain any interactions between the components, and provide separate information on the costs and charges.

Examples of this type of cross-selling package include car insurance sold with the option to buy a telematics device or private medical insurance sold with a wearable fitness device.

In packages where insurance is ancillary to other goods or service the customer must be able to buy the primary product or service without the insurance. Examples of ancillary insurance packages include insurance sold alongside mobile phones and cars. In these packages the ancillary insurance must be optional.

Insurance badged as being free to the customer is included within the new rules. The customer must be offered the ability to purchase the good or service separately to the insurance.

The IDD cross-selling provisions do not apply where insurance is sold ancillary to certain other financial products (such as payment accounts and mortgages) or ancillary to another insurance product. The cross-selling proposals do not change current expectations relating to the sales of multi-risk products or the sales of options/cover extensions offered within the one insurance product (such as accidental damage or baggage cover).

Firms are also reminded that the existing ICOBS rules will apply to an insurance policy sold as part of a package, irrespective of whether insurance was the primary or ancillary product in a package. This includes pre-contract disclosure requirements and the prohibition on opt-out selling.

Firms must continue to comply with the existing provisions relating to the sale of guaranteed asset protection (GAP) and insurance as part of a packaged bank account, as well as the rules and guidance on the sale of add-on insurance products.

H3B Product information

The IDD requires firms to provide customers with objective information about an insurance product in a comprehensible form to allow them to make informed decisions. The information provided should take into account the complexity of the insurance product and the type of customer. The existing ICOBS 6.1.5R (to be known as 'the appropriate information rule'), applicable to both retail and commercial customers, will be sufficient to encompass this requirement.



ICOBS 6.1.5 R

1. A firm must take reasonable steps to ensure that a customer is given appropriate information about a policy in good time and in a comprehensible form so that the customer can make an informed decision about the arrangements proposed.
2. The information must be provided to the customer:
 - a. whether or not a personal recommendation is given; and
 - b. irrespective of whether a policy is offered as part of a package with:
 - I. a non-insurance product or service (see ICOBS 6A.3 (Cross-selling)); or
 - II. another policy.
3. Appropriate information is both objective and relevant information, and includes IPID information [as required by ICOBS 6 Annex 3R, paragraph 2.1R].
4. Where the firm is proposing a policy (including if appropriate on renewal) 'in good time' means in good time prior to the conclusion of the policy.

The appropriate information rule applies at all stages of a contract and includes pre-conclusion and post-conclusion, and matters such as when mid-term changes and renewals are proposed. It also applies to the price of the policy; and in the same way to any policy, regardless of whether that policy is sold on its own, in connection with another policy, or in connection with other goods or services.

For non-life insurance products, the IDD requires that product information be provided in a standardised Insurance Product Information Document (IPID). For commercial customers firms may choose to provide some or all of the appropriate information in an IPID, a policy summary or a similar summary if it considers this to be a comprehensible form in which to provide that information; and should include the IPID information (regardless of whether an IPID is actually provided).

Although current requirements are not changing substantively, the FCA believes that product information can be improved for all customers. It has observed instances where product information is difficult to comprehend for customers, and particularly for small and medium enterprise (SME) customers that purchase more complex commercial products but behave in ways similar to retail consumers.

The FCA has emphasised its expectations that firms should provide product information that is objective, relevant and in a comprehensible form to customers.

On the Web

For full details of ICOBS and its application consult the FCA's website: www.fca.org.uk/firms/insurance-conduct-business-sourcebook-icobs.



I Client Assets Sourcebook (CASS)

Client Assets Sourcebook (CASS) is part of the FCA's Business Standards Handbook.

Client Assets Unit

This specialist unit of the FCA was created in direct response to the failure of Lehman Brothers at the height of the financial crisis to provide confidence in the UK regulatory regime's ability to deliver adequate protection of client money and safe custody of assets (client assets); a critical component for a successful financial services industry.

Source: Financial Conduct Authority, www.the-fca.org.uk/client-money-and-assets.



The FCA relies greatly on the quality of the protections afforded by the client assets regime because it helps to ensure that clients' assets and money are safe in the event of firms failing and exiting the market. Weaknesses in firms' client asset systems and controls can cause serious financial detriment to customers and counterparties, as well as reputational damage to the FCA and UK markets.

The mission of the Client Assets Unit is to help minimise the risk of financial loss from control failings and mitigate the damaging effects of such potential failures on consumers, firms and the FCA.

Key objectives

The Client Assets Unit has the following key objectives:

- To improve client asset risk identification, assessment and mitigation.
- To increase firm compliance with the Client Assets Sourcebook (CASS).
- To enhance the FCA's ability to react promptly to firm failure.

Desirable regulatory outcomes

- Clients to be confident that their assets are being held by firms with robust client asset controls as well as strong risk management.
- Clients to be assured that their client assets are safe and will be returned within a reasonable timeframe in the event of firm failure.
- The UK market to be regarded as a safe place to conduct business and encourage market entrants.

In August 2012, the FSA issued CP12/20 to review CASS as it applies to insurance brokers. The paper summarised its concerns as follows:



CASS 5 Client money: insurance distribution activity

Various concerns have arisen during the course of our review of CASS 5, which include poor understanding of the Rules and subsequent poor compliance, missing or incomplete documentation such as trust deeds and trust letters. We have also seen many examples of good practice and firms effectively protecting their clients' money.

Examples of specific issues of concern include:

- inappropriate controls around the use of the non-statutory trust;
- ineffective risk transfer documentation;
- application of the pooling rules;
- infrequent client money calculations;
- client money held by third parties; and
- client money held as designated investments.

Source: Financial Services Authority (2012) *CP 12/20 Review of the client money rules for insurance intermediaries*. Available at:

www.fca.org.uk/static/pubs/cp/cp12-20.pdf.

The paper set out a series of proposals as follows:

- Improving the effectiveness of segregation of client money and the use of risk transfer (where client money is held by the broker as the agent of the insurer and thus the risk is transferred from the client to the insurer).
- Simplifying the distribution of client money.
- Improving diversification of client money.
- Enhancing record-keeping and reconciliation.
- Enhancing the requirements on segregation and placement of client money.
- Improving governance and reporting to the regulator.
- A review of the rules in Section 53 of the **Marine Insurance Act 1906** which makes insurance brokers liable for marine premiums to underwriters in certain circumstances.

The FCA undertook a consultation of the CASS rules in 2013. It published its final rules in June 2014 and these rules were fully implemented in June 2015. However, the final rules make no changes to CASS 5. The current rules are described below.

CASS 5 contains the relevant provisions for insurance brokers. There are three approaches that, in theory, a broker can adopt:

- Hold money as an agent for one or more insurers.
- Segregate client money from its own in accordance with the rules.
- Both of the above.

Where a broker holds money as agent for an insurer, the terms of business agreement (TOBA) that the broker has with the insurer will need to explicitly state that the credit risk transfer basis applies. The CASS rules also require the broker to make clear to its clients that credit risk transfer is in place, as this can have implications for clients.

For example, once the broker is paid, the money becomes the property of the insurer and it cannot be refunded (even if that is the express wish of the client) unless the insurer consents.

In addition, with credit risk transfer the insurer agrees that in the event of the failure of the broker the insurer will subordinate its interests to those of the clients.

In theory, this should present little risk to the insurer as the money once collected by the broker must be held in an approved bank account and cannot be used by the broker for any other purpose. The potential for loss may arise if the broker has engaged in fraud.

I1 Client money segregation

Where the broker holds money on its own account, it must be segregated into a trust bank account which may be either a statutory trust or a non-statutory trust (CASS 5.4) and must be held in either a conventional deposit or current account.

A statutory trust does not permit the broker to use the money for any other purpose than as a holding point for onward transmission to either the insurer or, in the case of return premiums or claims, to the client. It also limits the way the funds can be invested.

A non-statutory trust allows the broker to co-mingle client and insurer money, advance credit to clients to enable them to meet their obligations to pay premiums and also gives more flexibility regarding investments. Neither type of trust allows a broker to withdraw commission or brokerage until the premium from which it is derived has been paid. In practice, such arrangements are only allowed by the FCA to the large, well-capitalised broking firms.

On the Web

The rules in relation to client money appear in CASS 5 of the FCA Handbook – for more information see:

www.handbook.fca.org.uk/handbook/CASS/



J Discipline and enforcement

According to the FCA, its principal purpose of imposing a financial penalty or issuing a public censure is to promote high standards of regulatory and/or market conduct by deterring persons who have committed breaches from committing further breaches, helping to deter other persons from committing similar breaches, and generally demonstrating the benefits of compliant behaviour. Financial penalties and public censures are therefore tools that the FCA may employ to help it to achieve its statutory objectives. In extreme cases, the FCA may use the criminal sanctions available under the Financial Services and Markets Act 2000 that could result in imprisonment.

In deciding what action to take, the FCA will take into consideration various factors set out in DEPP 6.2 including the nature, seriousness and impact of the suspected breach and whether the breach was deliberate or reckless, its duration and whether it exposes weaknesses in systems and so on. The FCA will also consider the conduct of the person(s) committing the breach during and after its discovery. Honest cooperation with the FCA will be a decisive factor.

The disciplinary measures available to the FCA are:

Public censure and public statements

The FCA may issue a public censure on a firm where it believes that the firm has contravened a requirement imposed on it by regulation, but that the conduct does not warrant the more serious penalty of a fine or prosecution. The criteria for deciding upon a public censure are described in DEPP 6.4.1 and 6.4.2. They include whether the censure will have a deterrent effect, the profit if any made from the breach, and the conduct of the person(s) involved.

Where the FCA proposes to issue a public censure or public statement, the firm or approved person in question will be given a warning notice setting out the terms of the censure or statement that the FCA intends to issue.

Financial penalties

The FCA can impose a financial penalty on a firm or an approved person. In DEPP 6.5A, the FCA sets out the five steps required to assess the size of the penalty, namely:

- disgorgement;
- seriousness of the breach;
- mitigating and aggravating factors;
- adjustment for deterrence; and
- early payment discount.



On the Web

Details of individual fines can be found on the FCA website:

www.fca.org.uk/news/news-stories/2018-fines.

Prosecution for criminal offences

Under the Financial Services and Markets Act 2000 the FCA has the power to prosecute for a wide range of offences. The following are examples (this list is not exhaustive):

- Carrying on or purporting to carry on a regulated activity without authorisation or exemption.
- Making false claims to be authorised or exempt.
- Communicating an invitation or inducement to engage in investment activity in breach of certain restrictions.
- Performing or agreeing to perform functions in breach of a prohibition order.
- Failing to cooperate with, or giving false information to, FCA-appointed investigators.
- Failing to comply with provisions about control over authorised persons.
- Providing false or misleading information to an auditor.
- Misleading the FCA.

The FCA has the power to prosecute these offences in England, Wales and Northern Ireland but not in Scotland, where the Crown Office remains responsible for prosecutions.

The FCA's general approach is to pursue through the criminal justice system all those cases where criminal prosecution is appropriate. In cases where criminal proceedings have commenced or will be commenced, the FCA may consider whether also to take civil or regulatory action. The action may include:

- injunctions;
- restitution;
- own-initiative action;
- withdrawal of approval or cancellation of permission and withdrawal of authorisation; and/or
- prohibition of individuals from carrying out functions in connection with regulated activities.

Suspension and restriction

Other measures are available to deal with such circumstances; for example, where there are questions concerning a firm's continuing ability to meet minimum standards, or where there are doubts about an approved person's fitness and propriety to perform the controlled function to which the FCA's approval relates. These measures include the:

- variation or cancellation of permission and withdrawal of the terms of authorisation;
- withdrawal of an individual's status as an approved person; and
- prohibition of an individual from performing a specified function in relation to a regulated activity.

Private warning

In particular cases, despite having concerns regarding the behaviour of a firm or approved persons, the FCA may decide that it is not appropriate, having regard to all the circumstances of the case, to bring formal disciplinary action. In such cases the FCA considers that it will be helpful for a firm or an approved person to be made aware that they came close to being subject to formal disciplinary action. To this end the FCA may, if appropriate, give a private warning.

For the larger firms, one of the benefits of maintaining close relationships with the FCA, despite the cost and time, is that issues can be resolved as they arise without recourse to the panoply of enforcement available to the FCA. This enables firms to manage change in an orderly way rather than it be imposed by regulatory action. Close cooperation is essential to avoiding the intrusiveness of a s.166 investigation.

Remember

No insurance policy, whether a directors and officers or errors and omissions policy, will cover fines or penalties imposed on the firm or on an approved person.

**Critical reflection**

Do you think the FCA achieves its objectives? Would many businesses consider the detail of the regulation to be good business practice?

**Section 166 of the Financial Services and Markets Act 2000**

Section 166 of the Financial Services and Markets Act 2000 gives the FCA the power to require firms to provide reports by skilled persons. These reports are prepared at the expense of the subject firm. They are normally conducted by the larger firms or accountants, solicitors and specialist consultants.

The FCA may choose to use a 166 to investigate issues arising from the **Firm Supervision Framework (FSF)** or from a specific incident such as an errors and omissions claim or a loss of client data. Recent subjects of 166 investigations have included capital adequacy (in the light of the collapse of the Lehman Brothers in 2008) and senior management structures.

The impact of a 166 investigation can be profound and time-consuming. The FCA may use this as a device to obtain information from a firm where it does not believe answers been adequately provided during a FSF visit have been complete and transparent.

The FCA is very likely to require recommendations arising from a 166 investigation to be implemented unless the subject firm can present convincing alternatives. The outcome of a 166 investigation will be subject to regular examination under the FSF.

K Product Intervention and Product Governance Sourcebook (PROD)

PROD is part of the FCA's **Business Standards Handbook**.

PROD 1, 2 & 3 do not apply to brokers but PROD 4 will come into force as a result of the IDD and the table below provides a summary of the main rules and guidance.

Table 5.9: Areas covered by PROD and rules laid down

Application	1.4.1 R	PROD 4 applies to brokers and insurers, with respect to manufacturing and distributing insurance products.
	1.4.2 G	Insurance product usually means a product for distribution to customers generally and not individual policies being sold or underwritten.
	1.4.3 R	PROD 4 does not apply in relation to the manufacturing or distributing of a contract of large risks, or a reinsurance contract.
When a broker may be considered to be manufacturing	1.4.4 R	Where an analysis of their activity shows that they have a decision-making role in designing and developing a product for the market. A decision-making role is assumed where brokers autonomously determine the essential features and main elements of a product, including its coverage, price, costs, risk, target market and compensation, and guarantee rights, which are not substantially modified by the carrier providing coverage. Personalisation of and adaptation of existing products in the context of broking for individual customers, as well as the design of tailor-made contracts at the request of a single customer, are not manufacturing.

Table 5.9: Areas covered by PROD and rules laid down

Product governance arrangements	4.2.1-4 R	Firms manufacturing a product must operate a proportionate and appropriate process for the approval of each product; and significant adaptations of an existing product before it is marketed or distributed to customers, taking into account: - the complexity of the product; - the degree to which publicly available information can be obtained; - the nature of the product and the risk of consumer detriment related to it; - the characteristics of the target market; and - the scale and complexity of the relevant business of the manufacturer or distributor. It should be simple for non-complex products compatible with the needs and characteristics of the mass retail market. But for more complex products with a higher risk of consumer detriment more exacting measures will be required.
Product approval process	4.2.5-7 R	The process must have means for designing, monitoring, reviewing and distributing, as well as for corrective action for products that are detrimental to customers. The means must be proportionate to complexity and risks related to the products as well as the scale and complexity of the manufacturer's business. The approval process must be documented in a 'product oversight and governance policy' available to relevant staff. Actions taken related to this procedure should also be documented, kept for audit purposes and made available to the competent authorities upon request.
	4.2.8 R	The product approval process must ensure that the design of products takes into account the objectives, interests and characteristics of customers; does not adversely affect customers; prevents or mitigates customer detriment; and supports a proper management of conflicts of interest.
Manufacture by more than one firm	4.2.13-14 R	A broker and insurer that are both manufacturers must have in place an agreement that specifies their collaboration to comply with the procedures to agree on the target market and their respective roles in the product approval process. In general when other firms collaborate to manufacture a product, they must outline their mutual responsibilities in a written agreement.
Target market	4.2.15-18 R	An identified target market must be identified and all relevant associated risks assessed taking into account the level of information available to the relevant customers and their financial literacy; and ensuring the intended distribution strategy is consistent and that steps are taken to ensure that the product is distributed to that market.
Product testing	4.2.22-26 R	Manufacturers must test their products, including scenario analyses where relevant, before bringing a product to the market. They must assess whether the product over its lifetime meets the identified needs, objectives and characteristics of the target market. The rules do not affect the manufacturer's freedom to set premiums but they should consider whether cost for the customer is consistent with its obligations under the Principles and ICOBS.
Distribution channels and information disclosure to distributors	4.2.27-29 R	Manufacturers must make available to distributors all appropriate information on its product approval process and the identified target market of the insurance product.
Monitoring and review of insurance products	4.2.34 R	A firm must regularly review the products it offers taking into account any event that could materially affect the potential risk to the identified target market. In doing so, the firm must assess at least whether the product remains consistent with the needs of the identified target market; and whether the distribution strategy remains appropriate.

L Passporting

One of the purposes of the IDD is to ensure there is an effective single market for insurance distribution activities. As was the case with the IMD, the main way of achieving this aim is through 'passporting'. This is the ability of a firm authorised in one European Economic Area (EEA) country to provide services in another EEA country without requiring additional authorisation.

A cross-border arrangement involves providing services to customers in another country through means such as the telephone and internet, without the firms having a permanent physical presence in the country concerned. It also includes services provided on a temporary basis, for example when visiting clients resident in other EEA States. The branch arrangement involves firms setting up a place of business in another country.

Article 6 of the IMD dealt with cross-border activity and the establishment of branches. Under the IMD, firms seeking to provide insurance mediation services, or undertake insurance mediation activities in another country had to notify their home regulator before they could use the passport. This regulator would then pass on the notification to the relevant regulator(s) in the country (or countries) where the firms wanted to do business.

The IMD passporting provisions were transposed through a mixture of legislation (primarily amendments to Schedule 3 of the Financial Services and Markets Act 2000) and Handbook changes (primarily SUP 13). Together these ensured that insurance intermediaries made the required passporting notifications.

The IDD makes various changes to the passporting regime and in particular, sets out a more detailed process than was previously the case under the IMD. The differences between the IMD and the IDD include new powers for the FCA in relation to refusing a notification of an intention to establish a branch. The IDD also sets out in greater detail, the respective obligations of home and host Member States.

However, the activities that can be passported remain the same. Furthermore, the new notification regime will apply to firms passporting for the first time; existing passporting firms will not be required to submit a new notification (unless they intend to passport into a new Member State).

The IDD sets out the information to be provided by a firm in a passporting notification, including the category of intermediary. The relevant forms will be amended in SUP 13 to reflect the additional IDD requirements.

Article 7(1) of the IDD allows regulators, in cases where a broker's primary place of business is located in a host state rather than its home state, to enter into agreements with each other for the host regulator to act as if it were the home state regulator. This is a new provision with respect to financial services regulation. The Treasury has consulted on the legislation required in order to allow this process to take place if required.

Following the UK's exit from the EU, the UK and the EU member states still enjoy the benefits of passporting while in the transition period.

After the end of the transition period the UK replicated the majority of the EU equivalence into UK law and granted the 27 countries in the block equivalence decisions based on a framework for third country to parts of the UK financial markets – as long as they meet the criteria. However, the EU is still to make its equivalence decision for the UK, and some of the business conducted in the UK has moved to the EU or to other global financial hubs. In January 2021, Amsterdam replaced London as the primary location for European Share Trading. Approximately 7,600 financial services jobs have moved from the UK to the EU, according to research produced by financial services firm Ernst & Young in March 2021.

Consider this...

At the time of publication, the UK's future relationship with the EU was still not solidified and remained a moving feast. What further agreement has been reached between UK and EU about the future trading relationship? How has that impacted on the brokers business models and the overall competitiveness of the industry?





On the Web

The Financial Services Act 2012 can be accessed by visiting:

bit.ly/2BprEQZ and bit.ly/2gyxTYt.

To read about the FCA's approach to regulation please see:

www.fca.org.uk/publication/corporate/fsa-journey-to-the-fca.pdf.

Details on the PRA's approach to insurance supervision can be found here:

bit.ly/2mm5oll.

To read about the PRA's approach to the regulation of deposit-taking institutions, see:

www.bankofengland.co.uk/publications/Documents/paapproach/bankingappr1603.pdf.

For further details about the Financial Policy Committee see:

www.bankofengland.co.uk/financial-stability.

CII Briefings

A specific briefing about the FCA can be found at:

bit.ly/2FAqHtk.

A specific briefing on the FCA guidance consultation on financial incentives can be found at:

www.cii.co.uk/media/3870676/cii_briefing_fsa_gc_financial_incentives_sep2012.pdf.

M Scenario 5.1: Approved persons

M1 Question

Your firm, which is a medium-sized regional broker with a revenue over £50m, has recently been acquired by a French broker. Two directors of the French parent have joined the board with one in an executive position. As a result of discussions with the FCA, they have advised that both of these directors are acting in a controlled function and must therefore become approved persons.

Prepare a high-level presentation for the board of the French broker that covers the key issues of the FCA regulation.

M2 How to approach your answer

Key points of content

You should aim to include the following key points of content:

Objectives of the FCA:

- Consumer protection: securing an appropriate degree of protection for consumers.
- Integrity: protecting and enhancing the integrity of the UK financial system.
- Competition: promoting effective competition in the interests of consumers in the markets for regulated financial services and services provided by a recognised investment exchange.

Sanctions and obligations:

- It is a criminal offence to carry on regulated activities without authorisation.
- Broking firms and individual approved persons who breach the regulations may be subject to FCA enforcement action which can include censure, fines and imprisonment.
- Regulated firms must establish that the insurers and other brokers they deal with are properly authorised or exempt.

High Level Standards:

- The Principles for Businesses.
- Systems of Senior Management Arrangements, Systems and Controls (SYSC).
- Threshold Conditions.
- Approved persons.
- Fit and proper test.
- Training and Competence.

The Principles for Businesses look for key behaviours such as:

- Conducting business with integrity.
- Managing conflicts of interest.
- Security of client money.
- Fair treatment of customers.
- Using the right degree of care and skill.

Senior Management Arrangements, Systems and Controls (SYSC) sets out rules and guidance regarding how a business is organised/managed. It covers these key areas:

- Organisation.
- Compliance.
- Audit – internal and committees.
- Risk assessment.
- Suitability of employees and agents.
- Business strategy and continuity.
- Management Information (MI).
- Management of records.

Threshold Conditions apply to:

- Legal status of the firm.
- Location of offices.
- Close links – the ability of the FCA to supervise the firm.
- Adequacy of resources – capital and human.
- Suitability of personnel.

Approved Persons performing controlled functions such as the CEO, business unit leader, finance director:

- Requirements are similar to the Principles for Businesses.
- Act with integrity and use appropriate skill and care.
- Observe proper standards of market conduct.
- Cooperate with the FCA.
- Ensure sound organisation and compliance with the rules and guidance of the FCA.

Self-test questions

1. Summarise the four main purposes of SYSC.
2. What are the important considerations for the fit and proper test?
3. What are the three pillars of the FCA's supervision model?
4. What are the factors that, in the opinion of the FCA, should be taken into account when determining whether an approved person has complied with Statements of Principle 5–7?

You will find the answers at the back of the book

6

Application of regulations and relevant law

Contents	Syllabus learning outcomes
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B Financial crime	2.1
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D Training and Competence (TC)	2.3, 2.6
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F Complaints	2.8
G Managing third parties	2.3, 2.9
H Bribery Act 2010	2.10
I Sanctions legislation	2.10
J Money laundering	2.10
K Record keeping	2.10
L Competition law	2.10
M Whistleblowing	2.10
N Scenario 6.1: Preventing financial crime	
Self-test questions	

This chapter relates to **syllabus section 2**.

Learning objectives

On completion of this chapter and your own private research, you should be able to:

- examine avoiding and managing conflicts of interest;
- explain the importance of training and competence;
- review the approach brokers needs to adopt in treating their customers fairly;
- explain the procedures for dealing with complaints;
- examine the management of third parties, appointed representatives and introducers; and
- explain the legal environment with reference to sanction and competition law.

Introduction

Refer to

Refer back to M81, section 6A4C, for information on the Consumer Credit Acts 1974 and 2006. You can find this on RevisionMate.

In chapter 5 we looked at key aspects of UK regulation, particularly the rules that exist within the principles-based approach of the FCA. Here we consider how those principles and rules are applied in practice in the areas of:

- compliance;
- financial crime;
- conflicts of interest;
- fair treatment of customers;
- managing third parties; and
- record keeping.

We then consider other aspects of the law that are as relevant to insurance brokers. Note the FCA's powers extend its remit to include compliance with these laws even though they form no part of the FCA regulation itself. We'll consider:

- sanctions;
- competition; and
- money laundering.



Key terms

This chapter features explanations of the following terms and concepts:

Appraisal	Bribery	Competency and skills frameworks	Competition law
Complaints	Conflicts of interest	Fair treatment of customers	Financial crime
Managing third parties	Money laundering	Record keeping	Sanctions
Training and Competence			

A Managing compliance



Broking management decision: Managing compliance

Do you set up your own compliance department or do you nominate a director with ultimate authority, but outsource the detail to a consulting firm?

What skills and competence would you look for in an individual compliance officer and in a specialist compliance firm?

The key compliance rule is SYSC 6.1.1, which says:

A firm must establish, implement and maintain adequate policies and procedures sufficient to ensure compliance of the firm including its managers, employees and appointed representatives (or where applicable, tied agents) with its obligations under the regulatory system and for countering the risk that the firm might be used to further financial crime.

In addition, the guidance goes on to say:

A firm should, taking into account the nature, scale and complexity of its business, and the nature and range of financial services and activities undertaken in the course of that business, establish, implement and maintain adequate policies and procedures designed to detect any risk of failure by the firm to comply with its obligations under the regulatory system, as well as associated risks, and put in place adequate measures and procedures designed to minimise such risks and to enable the FCA to exercise its powers effectively under the regulatory system.

The FCA does not specify in detail how it expects the compliance function to be organised. Based upon the guidance, the key issues are:

Table 6.1: Undertaking the compliance function – the key issues

The scale of the compliance function should reflect the scale of the broker	A five-person firm could legitimately outsource compliance, provided that the principal of the firm retains ultimate responsibility. The FCA will expect a fully resourced, independent function in the larger and global broking firms.
Implementation and maintenance of adequate policies and procedures designed to detect any risk of failure	These should also reflect the scale and complexity of the firms and should be designed to ensure that the firm is complying with its obligations such as treating customers fairly, disclosure and so on. They should be capable of internal and external audit.
Where the broker maintains a permanent compliance function it must operate independently and have responsibilities including:	To monitor and regularly assess both the adequacy and effectiveness of the measures and procedures put in place and the actions taken to address any deficiencies in the firm's compliance with its obligations. To advise and assist the relevant persons responsible for carrying out regulated activities to comply with the firm's obligations under the regulatory system.
The compliance function itself should have:	The necessary authority, resources, expertise and access to all relevant information. People who are not involved in the performance of the services or activities they monitor.
Remuneration of compliance personnel	The method of determining the remuneration of the relevant persons involved in the compliance function must not compromise their objectivity and must not be likely to do so.
Independent reporting lines	Reporting must be to a senior executive who is distant from day-to-day trading business. In larger firms, the FCA has made it clear that the compliance function within a business unit must not report through the line management of that business unit.
Separation of compliance and internal audit	Compliance determines and authorises the process and procedures for the implementation of compliance, whereas internal audit checks that they are being followed and reports accordingly. The internal audit function will also look at areas outside of compliance.

B Financial crime

One of the three objectives set out for the FCA in the **Financial Services Act 2012** is to protect financial markets – to protect and enhance the integrity of the UK financial system. In doing this, the FCA is concerned with:

- the soundness, stability and resilience of the financial markets;
- the transparency of the price information process in those markets;
- combating market abuse;
- the orderly operation of the financial markets; and
- reducing *financial crime* in the UK financial system.

The FCA states:



The approaches that you should take involve assessing the risks that your business may be used for the purposes of financial crime and then mitigating those risks effectively through:

- identifying your customers;
- understanding your relationship with them; and
- monitoring the way they use your services to identify anything suspicious.

Your systems need to be appropriate and proportionate to the nature and scale of your business. There is no 'one size fits all' approach that we expect firms to adopt. It will vary, for example, between large firms and small firms, firms operating in products or areas of high risk, and those offering products to customers where the firm assesses there is less financial crime risk.

Senior management should take clear responsibility for managing financial crime risks and be actively engaged in addressing these risks.

Your firm should:

- have a thorough understanding of its financial crime risks in order to apply proportionate systems and controls;
- have an organisational structure that promotes coordination and information sharing across the business;
- have appropriate up-to-date policies and procedures in place that can be easily accessed and understood by all staff;
- employ staff who have the skills and expertise to do their jobs effectively;
- review employees' competence and take appropriate action to ensure they remain competent for their role;
- manage the risk of staff being rewarded for taking unacceptable financial crime risks; and
- be able to provide evidence to demonstrate that it has adequate systems and controls to prevent the risk that it might be used to further financial crime.

Source: Financial Conduct Authority (2015) *Financial crime*. Available at:

www.fca.org.uk/firms/financial-crime.

The FCA's *Financial crime: a guide for firms*, published in April 2015, consolidates previous guidelines on managing financial crime. It covers:

- governance;
- management information (MI);
- structure;
- risk assessment;
- policies and procedures;
- staff recruitment, vetting, training, awareness and remuneration; and
- quality of oversight.



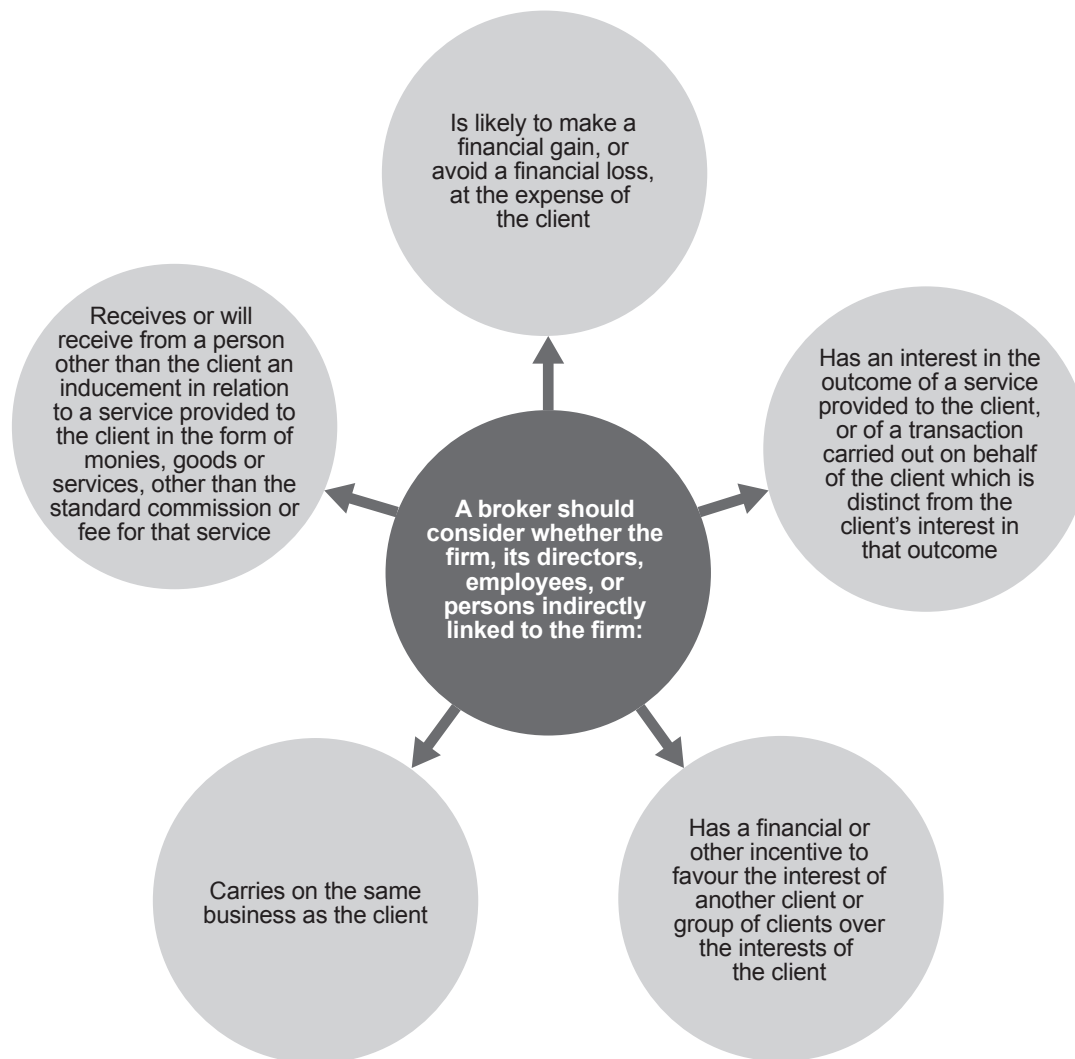
On the Web

You can read the FCA's *Financial crime: a guide for firms* at:

www.handbook.fca.org.uk/handbook/document/fc/FC1_FCA_20160703.pdf.

C Conflicts of interests

The following diagram describes areas of potential conflict:



The FCA's high-level requirements were updated to comply with the implementation of the Insurance Distribution Directive (IDD) and are set out at SYSC 10.1A. How these requirements apply to insurance brokers is summarised throughout this section.

Identifying conflicts

Brokers will need to assess whether they have an interest in the outcome of their activity which meets the following criteria:

- It is distinct from the customer's (or potential customer's) interest.
- It has the potential to influence the outcome to the detriment of the customer.

Brokers must proceed in the same way for the purposes of identifying conflicts of interest between one customer and another. This means taking into account, as a minimum, the following situations. The broker, a relevant person or any person linked (directly or indirectly) to them by control:

- is likely to make a financial gain or avoid a financial loss to the detriment of the customer;
- has a financial or other incentive to favour the interest of another customer (or group of customers) over the interest of the customer; and
- is substantially involved in the management or development of insurance-based investment products, in particular where there exists an influence on the pricing of those products or their distribution costs.

Types of conflicts

Firms must take into account, as a minimum, whether they or an employee:

- are likely to make a financial gain, or avoid a financial loss, at the expense of the client;
- have an interest in the outcome to the client or of a transaction carried out on their behalf, distinct from the client's interest in that outcome;
- have a financial or other incentive to favour the interest of another client over the interests of the client; or
- receive from someone other than the client an inducement in relation to the service provided to the client (in the form of monies, goods or services) other than the standard commission or fee for that service.

Record of conflicts

Firms should keep and regularly update a record of the situations in which a conflict of interest entailing a risk of damage to the interests of a customer has arisen or (in the case of an ongoing service or activity) may arise. Senior management shall receive on a frequent basis (at least annually) written reports on these situations.

Managing conflicts

Firms must maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps to prevent conflicts of interest from giving rise to a material risk of damage to the interests of their clients.

Conflicts policy

Firms should maintain an effective conflicts-of-interest policy in writing appropriate to the size and complexity of their business.

Where the broker is a member of a group, the policy shall also take into account any circumstances (of which the broker is or should be aware) that may give rise to a conflict of interest arising as a result of the structure and business activities of other members of the group.

The policy should include the:

- circumstances that constitute or may give rise to a conflict of interest entailing a risk of damage to the interests of one or more clients; and
- procedures to follow and measures to adopt in order to manage such conflicts and prevent them from damaging the interests of the customer.

These procedures and measures should include (where appropriate):

- effective procedures to prevent or control the exchange of information where it may damage the interests of one or more customers;
- the separate supervision of relevant persons whose principal functions involve carrying out activities on behalf of (or providing services) to customers whose interests may conflict (or who otherwise represent different interests that may conflict), including those of the broker;
- the removal of any direct link between the remuneration of relevant persons principally engaged in one activity and the remuneration of, or revenues generated by, different relevant persons principally engaged in another activity, where a conflict of interest may arise in relation to those activities;
- measures to prevent or limit any person from exercising inappropriate influence over the way in which broking is carried out;
- measures to prevent or control the simultaneous or sequential involvement of someone in separate insurance distribution activities where such involvement may impair the proper management of conflicts of interest; and
- a gifts and benefits policy which determines clearly under which conditions gifts and benefits can be accepted or granted and which steps are to be taken when accepting and granting gifts and benefits.

Brokers shall assess and periodically review, on an at least annual basis, their conflicts of interest policy and take all appropriate measures to address any deficiencies.

Disclosure of conflicts

Brokers shall avoid over-reliance on disclosure such as to ensure that it is a measure of last resort that is used only where the effective organisational and administrative arrangements

established to prevent or manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to the interests of the customer will be prevented.

For the purposes of a disclosure of conflicts of interest brokers should:

- provide a specific description of the conflict of interest in question;
- explain the general nature and sources of the conflict of interest;
- explain the risks to the consumer that arise as a result of the conflict of interest and the steps undertaken to mitigate those risks; and
- clearly state that the organisational and administrative arrangements they have established to prevent or manage the conflict of interest are not sufficient to ensure that risks of damage to the interests of the customer will be prevented.

Launch of the conflicts-of-interest thematic project

The FCA has a slightly different approach to conflicts of interests than the FSA did. This approach was summarised in the speech given by Simon Green, Head of General Insurance and Protection at the FCA, reproduced in full in appendix 5.1 on RevisionMate. In it he stated:

Conflicts of interest

Another area I am keen to explore is conflicts of interest. I am particularly interested in how insurance brokers identify and manage potential conflicts where they receive revenue from both their customers and insurers.

To be absolutely clear, when I talk about revenue received from insurers I do not mean the payment of broking commission in a normal range. I am talking about profit share, volume arrangements and other payments received from insurance companies.

We need to establish whether the flow of this type of revenue from insurers to brokers acting as agent of a customer might:

- unduly influence a broker to recommend an insurer against the customer's best interest, and/or
- cause a broker to improperly perform its duties to its customer.

That's why today we are launching a strategic thematic review into how UK insurance brokers manage conflicts of interest.

Insurance brokers' business models have changed radically over the last 20 years. Some brokers have shifted from being 'vanilla' product distributors to product designers, underwriters and claims handlers through delegated underwriting and claims authorities. An increasing number of brokers now take on many of the value chain functions historically performed by insurers. This means conflicts of interest may have mutated into a very different risk.

The review will focus particularly on SME and microbusiness customers. The SME customer segment is a major employer and the 'engine room' of the economy. It is also a mass market – according to the Department for Business, Innovation and Skills there were an estimated 4.8m private sector businesses in the UK at the start of 2012.

The recent interest rate swaps experience demonstrates that although SME customers can be sophisticated in terms of the businesses they operate, it does not necessarily follow that they are sophisticated buyers of financial products and services.

This work will help us test whether the essential everyday insurance products that those businesses need are designed and delivered fairly. We will look to trade associations such as BIBA and LIIBA to work with us collaboratively as this work progresses.

I will expect my team to deliver its findings, and final recommendations, by the last quarter of this year. (2013)

Source: Financial Conduct Authority (2013) *What does the future of insurance broking look like?* Available at: www.fca.org.uk/news/future-of-insurance-broking.





Research exercise

Consider all of the possible areas where conflict may arise in insurance brokers; some examples might include:

- insurers offering differing rates of brokerage for similar, but not identical, cover;
- offers of inducements, such as enhanced brokerage, to place more business;
- the same division of a broker controlling an MGA and placing client business with it; or
- the reinsurance division of a broker placing pressure on the direct division to place more business with a specific insurer client.

In addition, list ways to deal with each of these and any other examples of potential conflicts you have experience of. Evaluate your performance in dealing with them. What worked well and what could have been done to improve the outcome?

Findings from the FCA conflicts-of-interests thematic project

The findings from this review were eventually published in May 2014 and the conclusions reached are listed below:

- Control frameworks had not developed at the same pace as their business model.
- Tender processes sometimes appeared to focus predominantly on remuneration, with little consideration of customer needs.
- Some firms appeared to rely largely on disclosure (per ICOBS 4) with not enough focus on mitigating or managing conflicts (per SYSC 10).
- Some of the disclosure provided to customers was very generic and not tailored to the customer.

Even though the FCA drew its conclusions from a review of only seven firms with a particular business model, brokers more widely are encouraged to consider the findings and how they might improve their conflicts management as a result.

Broker conflicts of interest was again examined in the Wholesale Insurance Broker Market Study, where the final report was published February 2019 and discussed in chapter 5.

Conducting a GAP analysis against the findings of the review is one way of looking at a firm's own arrangements in the areas identified.

Since the implementation of the IDD, SYSC 19F 2.2R now applies. In summary, firms must not be remunerated, remunerate or assess the performance of their employees, in a way that conflicts with their duty to comply with the customer's best interests rule (ICOBS 2.5.-1R).

In particular, they must not make any arrangements by way of remuneration, sales target or otherwise that could provide an incentive to itself or its employees to recommend a particular policy to a customer when the broker could offer a different one that would better meet the customer's needs.



On the Web

You can read the FCA's thematic review into conflicts of interests here: www.fca.org.uk/static/documents/thematic-reviews/tr14-09.pdf.

D Training and Competence (TC)

Training and Competence (TC) rules form part of the FCA's High Level Standards.

Firms need to meet competence requirements in three principal areas under TC. These are:

- assessing competence;
- maintaining competence; and
- record-keeping.

The FCA states that firms should make sure employees are suitably supervised and have relevant qualifications for their job roles. For insurance broking there are no specific requirements for qualifications; however, a broking business must assess staff capability and provide evidence of their training and suitability.

Table 6.2 lists the relevant rules.

Table 6.2: Training and Competence rules

Rule	Rubric
TC 1.1.1	TC only applies to employees who provide advice on general insurance to consumers.
SYSC 5.1.4A	Firms carrying on activities that are not subject to TC (e.g. commercial broking) may nevertheless wish to take TC into account in complying with the competence requirements in SYSC. ('May' makes it good practice, but it is not 'should' or 'must'.)
SYSC 3.1.6 or 5.1.1	A firm must employ personnel with the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them.
TC 2.1.1	A firm must not assess an employee as competent until the employee has demonstrated the necessary competence. This assessment need not take place before the employee starts to carry on the activity.
TC 2.1.2	A firm must not allow an employee to give advice to consumers without appropriate supervision.
TC 2.1.3	The level and intensity of supervision will be significantly greater in the period before the firm has assessed the employee as competent. Firms need clear criteria and procedures relating to the specific point at which the employee is assessed as competent in order to be able to demonstrate when and why a reduced level of supervision may be considered appropriate. At all stages firms should consider the level of relevant experience of an employee when determining the level of supervision required.
TC 2.1.4	Firms should ensure that supervisors have the necessary coaching and assessment skills as well as technical knowledge and experience.
TC 2.1.11	Firms should ensure that their employees' training needs are assessed at the outset and at regular intervals (including if their role changes). Appropriate training and support should be provided to ensure that any relevant training needs are satisfied. Firms should also review at regular intervals the quality and effectiveness of such training.
TC 2.1.12	A firm must review on a regular and frequent basis employees' competence and take appropriate action to ensure that they remain competent for their role.
TC 3.1.1	A firm must make appropriate records to demonstrate compliance with the rules in this sourcebook and keep them for three years after an employee stops carrying on the activity.

The implementation of the above naturally varies widely among firms, and not just according to their size. Most firms of brokers believe that they can only be effective and produce the required business results if their employees are, and remain, competent in their job roles.

Firms adopting best practice in this area therefore place great importance on the training and **continuing professional development (CPD)** of employees at every level, expecting them to demonstrate a high level of expertise and knowledge at all times. Many firms will expect their employees to have a **personal development plan (PDP)**. This is to encourage employees to set goals for self-improvement and professional development which are supported by their employer.

With the implementation of the IDD, sections of the new rule summarised in table 6.3 are also relevant.

Table 6.3: Insurance distribution: specific knowledge, ability and good reputation requirements (SYSC 28)**Knowledge and ability requirements**

SYSC 28.2.1R	This is applicable to relevant employees. Principally, those directly involved in the carrying on of the firm's broking activities, are within the management structure responsible for it or are responsible for the supervision of a relevant employee. Firms must ensure that it (and each relevant employee) possesses appropriate knowledge and ability in order to complete their tasks and perform their duties adequately. A firm must ensure that it and each relevant employee complies with continued professional training and development requirements in order to maintain an adequate level of performance corresponding to the role they perform and the relevant market. Firms must ensure that each relevant employee completes a minimum of 15 hours of professional training or development in each 12-month period.
SYSC 28.2.3R	Firms must (including in relation to the relevant employee) demonstrate compliance with the following professional knowledge and competence requirements for general insurance contracts, the minimum necessary: • knowledge of terms and conditions of policies offered, including ancillary risks covered by such policies; • knowledge of applicable laws governing the distribution of products, such as consumer protection law, relevant tax law and relevant social and labour law; • knowledge of claims handling; • knowledge of complaints handling; • knowledge of assessing customer needs; • knowledge of the insurance market; • business ethics standards; and • financial competence.

Good reputation requirements

SYSC 28.3.1R	Firms (other than a connected travel insurance intermediary) must ensure that all the persons in its management structure and any staff directly involved in insurance distribution activities are of good reputation.
SYSC 28.3.4R	In considering a person's reputation the firm must at a minimum ensure that the person: • has a clean criminal record or any other national equivalent in relation to serious criminal offences linked to crimes against property or other crimes related to financial activities; and • has not previously been declared bankrupt, unless they have been rehabilitated in accordance with national law.
SYSC 28.3.6G	A firm's systems and controls should enable it to satisfy itself of the suitability of anyone who acts for it. This includes, but is not limited to, the assessment of an individual's honesty.

Record-keeping requirements

SYSC 28.4.1R	Firms must establish, maintain and keep appropriate records. Firms must also be in a position to provide to the FCA, on request, the name of the person responsible for this record-keeping requirement.
SYSC 28.4.2R	Firms must make an up-to-date record of the continued professional training or development completed by each relevant employee in each 12-month period; retain that record for not less than three years after the relevant employee stops carrying on the activity; and be in a position to provide any version of the record to the FCA on request.
SYSC 28.4.3R	Firms must not prevent a relevant employee from obtaining a copy of the records relating to them which are maintained by the firm for the purposes of SYSC 28 compliance.

D1 Recruitment and internal promotions

At the recruitment stage, all job applicants should complete an appropriate application form and provide evidence of their previous employment, availability to work legally in the UK, qualifications and training where this is relevant. While the firm should check these references, the reality is that many businesses are reluctant to give detailed references.

Some will only confirm that the employee worked between certain dates and perhaps their absence record. Therefore, it is essential for any position of responsibility, especially for

approved persons and those supervising other staff and those where technical competence is a requirement, that:

- a wide range of 'informal' opinions should be sought;
- candidates undergo a detailed assessment of their skills and competence in technical and relevant managerial aspects of the role. This may be done through a combination of formal interviews where appropriate searching questions are asked, role playing, by written tests, computer-based assessments; and
- the role should be clearly specified with a clear job description, skills and competencies required, and the levels of authority, responsibility and reporting lines upwards and downwards.

The second and third steps should be applied as a matter of good practice to internal appointments and promotions.

For graduate recruitment, many firms use formal assessment processes that examine all aspects of a potential recruit's knowledge, skills and competencies. Many firms also make it a condition of employment that the candidate will achieve a suitable examination qualification; for example, the ACII, within a certain time.

Not only does assessment ensure that new staff are competent, it also sets a standard for the natural development of more advanced technical skills training and education, and in facilitating appraisals.

Appointment letters should provide a detailed job description, a summary of the qualities and behaviour expected, objectives and key performance indicators (KPIs). They should also set out probation periods and specify any exam requirements the new recruit needs to complete within a given timescale.

D2 Competency and skills frameworks and related training

Competency and skills (CS) frameworks are an effective management tool, especially for the development, attraction and retention of highly skilled staff. They also have the benefit of demonstrating structure and method and are capable of being audited; all features that appeal to the FCA. They also support applications for, and maintenance of, CII Chartered Broker status that can aid the development of the profession as a whole.

A simplified framework is illustrated in appendix 6.1 on RevisionMate. This has been derived from the framework published by the CII.

Table 6.4: How the CS frameworks influence firms' practice

How the frameworks are used	How the firm delivers training
To define the range of skills and competencies required for each role within the business. In simple terms, for example, all staff might be required to have a good basic level of insurance technical knowledge, whereas for new business teams the focus will be on selling and interpersonal skills, and the team leader of a technical client service team might require more advanced technical knowledge.	Formal technical training sessions that may be short (e.g. 'lunch and learn') to longer, perhaps residential, courses lasting several days. The former tend to be used for technical issues, whereas the latter tend to be used for a mixture of technical and managerial skills.
To assess progress in line with the firm's strategy.	Specific courses to deal with regulatory issues, such as Treating Customers Fairly or money laundering.
To assess the actual skills available against the ideal so as to identify TC needs to define the total TC requirement.	Supporting external qualifications such as MBAs on a part- or full-time basis, or degrees at institutions (e.g. the Open University) and paying the costs of taking relevant examinations, e.g. the ACII.
As part of individuals' annual appraisals through individual learning goals and general performance management.	Intensive management courses for senior staff at business schools.

Whatever method is used, what is often missing from any training programme is the assessment of how effective the training method adopted is. The firm will want to know if the method adopted works and if individuals have benefited from the training, and indeed are making progress in improving themselves.

Therefore these frameworks and the training resulting from them require the discipline of some form of regular assessment, with regularity being defined by the role level and knowledge required.

In essence, this means testing staff against the knowledge requirements of the firm's framework. A variety of techniques might be used, from computer-based question sets, interviews with more senior colleagues, observed visits, more formal written tests and progress with qualifications such as the ACII and so on.

Firms may choose to set minimum standards and job-related levels of technical and other competencies, as well as allowing individuals the freedom to develop further by encouraging study towards professional examinations and appropriate external education. This should be supplemented with training in regulatory issues such as the broad requirements of the FCA, money laundering, anti-bribery and employer-specific codes in such areas as equal opportunity.

Employee knowledge and ability requirements are being updated by the implementation of the IDD. The IDD requires that insurance distributors and their employees have appropriate knowledge and ability. This is demonstrated by completing a minimum of 15 hours of CPD each year. The IDD sets out criteria for minimum knowledge, which include areas such as product and market knowledge.

Firms are currently required by SYSC to ensure their employees have the knowledge, skills and expertise necessary to carry out their responsibilities. The FCA is not planning to increase this nor does it believe there is a strong case for a mandatory qualification.

The IDD minimum knowledge criteria only apply to insurance and reinsurance brokers. However, the FCA proposes to apply them also to insurers and reinsurers. The minimum knowledge criteria include areas such as product coverage, the claims process and insurance regulation. These are just as relevant to insurers distributing products directly to the customer as they are to brokers.

The requirements apply only to those employees directly involved in insurance distribution and their supervisors and managers but includes employees such as call centre operatives whose role may be limited to conducting non-advised, script-based sales.

Firms should already maintain records of employee competence as part of compliance with SYSC requirements. Firms must not prevent employees from obtaining a copy of their CPD records, which should be held for not less than three years.



Broking management decision: The ideal skill set

Define the range of skills needed for a general broker employing 50 people with a business mix of your choosing. Remember that not all of the staff will be insurance professionals.

D3 Monitoring and appraisal

Appraisals should be carried out at least annually and performance assessed against job descriptions, objectives and KPIs. Training needs that were previously identified, but have not been addressed, should also be resolved. The firm will need a method of recording appraisals and keeping the records for an appropriate time.

It is good practice to reserve the appraisal for an in-depth review of progress, as the basis for considering performance against objectives and KPIs and to set the personal development plan for the future. This should be aligned with regular one-to-one discussions between the employee and immediate supervisor. Timekeeping, discipline and readily identifiable performance issues should be dealt with instantly and not at the annual appraisal.

A requirement will normally exist for all staff to complete measurable continuous professional development (CPD) activities. The CII, as well as a number of insurers and independent companies, offer online tools to do this.

D4 Does the TC regime deliver for firms and does it meet the FCA's objectives?

In 2010 the FSA had commissioned the Cattellyst Consultancy (Cattellyst) to undertake research to help it determine if its Training and Competence (TC) regime continued to provide the desired outcomes.

The TC regime was last revised in 2007. Since then the regulatory environment has continued to evolve and a number of initiatives have affected the TC agenda, including the review of Effective Corporate Governance and the Retail Distribution Review (RDR) proposals regarding professionalism. While the research was not aimed primarily at general insurance, some of the findings are relevant to insurance broking. They have been summarised below (some have been omitted for clarity). Note the RDR only applies to retail investment business.

1.	The style of TC arrangements varies between firms, larger employers tending to have more rigid structures and smaller firms having a more flexible approach. While there are examples of excellence in firms of all sizes, in a number of firms TC is still considered more as a compliance requirement than as a lever for competitive advantage. TC effectiveness is almost always a direct reflection of the culture of the firm and the priority given to professionalism by the most senior staff.
2.	Comments from all sectors indicate that the current TC regime would benefit from a comprehensive review. The MPBR (Move to Principles Based Regulation) approach has only brought modest benefits at the cost of significantly increasing uncertainty within firms about FCA's expectations.
4.	There are calls from all sectors for increased certainty and clarification. Greater detail in the requirements would be welcomed, though there is no desire for a prescriptive approach.
5.	Firms find it difficult to determine what is sufficient to meet regulatory TC expectations. Transparency about FCA's judgment criteria would be welcomed, as would case examples of what FCA deems to be good practice.
6.	TC should be business focused, delivering benefits for clients and firms rather than being merely a compliance obligation. The business focus should be reinforced by any amendments made to the regime and any changes should be pragmatic. The current regime is seen to be orientated towards larger employers with access to significant in-house resources.
7.	The TC regime is seen to place an over-emphasis on knowledge and qualifications with insufficient attention being paid to application and leadership skills. (But note that there are no qualification requirements in the TC regime for insurance brokers.)
8.	Greater harmonisation between the TC and approved persons regimes would be welcomed.
10.	Currently, the Competent Employees Rule is not well understood, nor are its implications fully appreciated. Where TC arrangements are not fully harmonised, there are likely to be differentiated standards between those individuals in and out of scope and between retail and non-retail activity.
11.	Responsibility for TC and the management of professionalism and competence is inconsistent between firms. There is currently no formality or guarantee about direct Significant Influence Function (SIF) engagement with the professionalism and competence agenda.
13.	There is a widely held view that TC is not a regulatory priority. Firms would like to see evidence that FCA takes TC seriously and is prepared to enforce the requirements of the regime.

Perhaps the key comments are that TC should not be seen as a compliance obligation but as a source of competitive advantage. This is one of the key ideas behind the Chartered Broker status described in [Chartered Broker status](#) on page 9/14.

E Fair treatment of customers



Fair treatment of customers

Fair treatment of customers is an aspect of the Principles for Businesses upon which the FCA (previously the FSA) has placed particular emphasis. The FCA states:

All firms must be able to show consistently that fair treatment of customers is at the heart of their business model.

Above all, customers expect financial services and products that meet their needs from firms they trust.

Source: Financial Conduct Authority (2015) *Fair treatment of customers*. Available at: www.the-fca.org.uk/firms/fair-treatment-customers.

In accordance with the FSA's principles-based approach, it did not prescribe how fair treatment of customers is achieved. However, the FSA did describe a number of outcomes for consumers and these continue under the FCA. It would expect a similar approach for commercial clients, but one that is proportionate to their knowledge and experience; for example, firms with professional insurance or risk managers would be treated differently to a small business.

The FCA's expected outcomes for fair treatment of customers are:

Outcome 1	Consumers can be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture
Outcome 2	Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly
Outcome 3	Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale
Outcome 4	Where consumers receive advice, the advice is suitable and takes account of their circumstances
Outcome 5	Consumers are provided with products that perform as firms have led them to expect, and the associated service is of an acceptable standard and as they have been led to expect
Outcome 6	Consumers do not face unreasonable post-sale barriers imposed by firms to change product, switch provider, submit a claim or make a complaint

Source: Financial Conduct Authority (2015) *Fair treatment of customers*. Available at: www.the-fca.org.uk/firms/fair-treatment-customers.

The FCA expects companies to embed the principle of fair treatment of customers in their corporate strategy and build it into their firm's culture and day-to-day operations. It expects all employees to understand the principles of fair treatment of customers and the approach adopted by their employer.

In response to the standard rejoinder that 'If I did not treat my customers fairly, they would not come back', the FCA's view is that brokers should not confuse satisfaction with fairness. Where the customers are satisfied because they do not realise that they have not been fairly treated, the satisfaction does not make the 'unfairness' correct. Equally, customers with unrealistic expectations might feel dissatisfied even though they have been treated fairly.

Fair treatment of customers is not an embargo on new products, does not require customised products for each customer and should not inhibit the development or promotion of generic communications. Fair treatment of customers **does** mean that the target market must be considered and effective systems and controls put in place to ensure that the broker acts in a way that:

- is likely to be fair for the customer groups being targeted; and
- ensures that customers are not exposed to unsuitable or unidentified risks for any newly developed products.

In response to firms' roundly expressed desire for more specific direction from the FCA in its intentions for fair treatment of customers, the FCA published 'The responsibilities of

providers and distributors for the fair treatment of customers' (RPPD), which can be found in the FCA Handbook in the Regulatory Guides section.

This guidance is not binding and need not be followed in order to achieve compliance with rules or other requirements. Departing from it does not indicate a breach of a rule. However, it may be relevant in an enforcement context; for example, to explain the regulatory context.

Importantly, if anyone acts in accordance with the guidance, then the FCA will not take action against them in relation to the aspects of the rules to which it relates. The guidance is used by the FCA supervisors in their discussions with firms.

The regulation concerning the development of new consumer products will be changing as a result of FSA discussion paper DP11/1 published in January 2011, the subsequent feedback paper and a thematic review (TR 15/02) published by the FCA in March 2015. Further reference to this is made in [Transparency](#) on page 12/9, but to summarise, the FCA will look at products from a holistic point of view rather than basing consumer protection around the point of sale and disclosure.

The way in which the philosophy of the FCA will evolve with respect to fair treatment of customers was effectively summarised in the speech by Simon Green:

FCA and the fair treatment of customers

Our supervisory experience shows the cost to customers where firms don't get the basics right. Our experience also shows how doing the simple things well hugely enhances the customer experience, and increases retention.

With this in mind, I would like to leave you with some questions to reflect on. These are the type of questions our supervisors will be asking you in risk assessments, testing your culture on the ground, and discussing with you at our road shows and workshops:

- How do you demonstrate you identify and manage potential conflicts of interest effectively?
- Is your customer a genuine client, or an upsell opportunity? For example, do you sell add-ons and premium finance fairly?
- How do you make sure products and fees are properly disclosed and well understood by customers?
- Are your staff incentives consistent with delivering good customer outcomes?
- What does your complaints handling say about your culture?
- What due diligence do you undertake when using unrated insurers?

Source: Financial Conduct Authority (2013) *What does the future of insurance broking look like?*. Available at:

www.fca.org.uk/news/future-of-insurance-broking.



E1 Consumer communications

Effective communications can help improve consumer choice and decision-making. This can be achieved by providing information about products and services in a manner that is both engaging and comprehensible and by providing information at the appropriate time and through appropriate channels. Information alone is not sufficient to empower consumers to make informed choices, as different people engage with information in different ways.

Historically, the FCA (and previously the FSA) has required firms to provide consumers with information in the form of regulatory disclosures. Firms have also provided consumers with information that they consider relevant to their products or services as part of their wider communication.

This information has typically been provided in paper-based format with little consideration of whether consumers actually read, process and ultimately incorporate that information into their decision-making process. When disclosure gets too much, it can lead to 'information overload'.

While this approach was designed to help consumers, it does not always meet today's consumer information needs nor help them understand the products or services that they have or plan to buy. Consumers need:

- better practice and a more flexible approach around communications;
- simple, clear information and explanations; and
- to be able to trust firms.

Moreover, consumers who choose to use digital channels need communications that are suitable for today's digitalised context. Technology has transformed how consumers research, choose, buy and use financial products.

For example, consumers now often apply for financial services online. Consumer engagement can best be achieved through rethinking, not just what it is communicated, but also how it is communicated with consumers. Consumers are engaging with new communication technologies, leading to fast-changing habits and preferences. A predominately paper-based disclosure may not meet today's consumer information needs.

The FCA launched its Smarter Consumer Communications initiative to bring about a change in the way information is both communicated and delivered to consumers. To deliver this, it requires a fundamental change in mindset about how to communicate effectively with consumers. The pace of innovation means that both firms and regulators need to be able to adapt quickly to the fast-changing needs and expectations of consumers.

The challenge is to ensure that regulation can keep pace with changes in the market and support innovation. The overall ambition is to create an environment and regulatory framework where firms' communications encourage and enable informed consumer engagement and decision making regarding financial products and services.

FS16/10: Smarter Consumer Communications

In March 2016, FCA published a Feedback Statement (FS16/2) on its Call for Input (CFI) on *Regulatory Barriers to Innovation in Digital and Mobile Solutions*. The FS16/2 outlined six themes where respondents suggested there was a regulatory barrier to their attempts to innovate with digital or mobile solutions. One of the themes identified was how the rules on communication apply to digital and mobile solutions.

Firms expressed their views that elements of the current regime were unsuitable for innovative forms of communication. This feedback overlapped with the work already underway through the Smarter Consumer Communications initiative. A number of respondents also noted that their comments on the CFI on *Regulatory Barriers to Innovation* replicated those provided in response to the Smarter Consumer Communications work.

Given the convergence of these two initiatives and the specific focus FS16/2 gives to communication, the FCA addressed the issues raised in response to its CFI on *Barriers to Innovation* in *Feedback Statement: Smarter Consumer Communications (FS16/10)*.

The FS16/10 was published in October 2016 and it sets out the work undertaken by the FCA to research the market's approach to communication, examine the issues arising and seek a way forward to effect improvements for financial services customers across a broad spectrum.

The Statement concluded that smarter communications should inform, educate and empower consumers. They can help consumers to take greater responsibility for their financial affairs and overcome inertia.

The FCA is aiming to create a regulatory framework that supports consumer communications that are clear and simple to understand, and encourage the use of new technologies to present things in ways that interest and engage consumers.

Equally, industry has a critical role to play in improving consumer communications and the FCA expects firms to ensure that their communication with consumers is 'smart'.

In order to achieve its goals, the FCA intends to launch the following initiatives:

- Hosting a Smarter Consumer Communications event to further engage with stakeholders on key issues.
- Reviewing the issues raised around Social Media Guidance through consumer testing to seek to identify innovative approaches that may address concerns especially around risk warnings.

- Consulting on good disclosure guides, including digital disclosure.
- Consulting to change disclosure rules, or accompanying guidance where they have been identified as barriers to smarter communications or innovations.
- Reviewing the use and definition of 'durable medium' in the FCA handbook and consulting on possible updates.
- Investigating instances where firms provide unhelpful disclosure or risk warnings to consumers that reduce the overall effectiveness of communication. The FCA will reduce or remove unhelpful and unnecessary provisions of information when possible.
- Responding to the issues raised in the financial advice market through the Financial Advice Market Review (FAMR). The FCA will work with the Association of Professional Financial Advisers (APFA), the Personal Finance Society (PFS) and the Financial Ombudsman Service (FOS) to help the industry develop guidelines for preparation of suitability reports to make them more accessible for consumers and reduce the time firms spend preparing them.

On the Web

You can read FS16/10 in full at:

www.fca.org.uk/publication/feedback/fs16-10.pdf.



E2 Consumer vulnerability

This topic was the subject of the FCA's Occasional Paper No.8, published in February 2015. This paper did not introduce new rules or other mandatory compliance requirements, but it is worth noting its aims which were to:

- broaden understanding and stimulate interest and debate around vulnerability;
- provide practical help and resources for firms in developing and implementing a vulnerability strategy; and
- show examples of good practice in the way some firms treat consumers in vulnerable circumstances.

Our industry has come under significant pressure in the last few years to rediscover its sense of social purpose. We believe that vulnerability is an issue that should be at the centre of that debate – and it's clear that this is becoming an increasingly significant issue for consumers too ... Firms have legal responsibilities and a duty under our rules to ensure customers are treated fairly.

Source: Wheatley, M. in Financial Ombudsman Service (2015) 'Powers of attorney', *Ombudsman News*, issue 124 March/April. Available at:

www.financial-ombudsman.org.uk/publications/ombudsman-news/124/124-ombudsman-focus.html.



In February 2021, the FCA published their finalised guidance for firms on the fair treatment of vulnerable customers. The purpose of the guidance was to ensure that vulnerable customers are given the appropriate degree of protection and experience outcomes as good as those for other customers.

A vulnerable customer is one who, due to their personal circumstances, is especially susceptible to harm, particularly when a firm is not acting with appropriate levels of care.

Firms are expected to provide their customers with a level of care which takes into account the characteristics of each customer.

On the Web

www.fca.org.uk/publication/occasional-papers/occasional-paper-8.pdf

www.abi.org.uk/products-and-issues/lts-public/issues-in-long-term-savings/vulnerability-guide



E3 Importance of ethical behaviours in delivering positive customer outcomes

The principles set by the FCA reflect the professional and ethical standards that should guide those who work in insurance as they go about their day-to-day activities. However, it's vitally important for an industry that relies on trust for customers to have confidence that they are dealing with people who are putting their interests first; not because they have to, but because they believe it's the right thing to do.

Organisations with a record of great customer service, treating every customer fairly and with respect, build themselves a good reputation; those who don't won't be recommended to other people.

The CII Code of Ethics provides members of the insurance and personal finance profession with a framework in which to apply their role-specific technical knowledge in delivering positive consumer outcomes. Under the fifth 'Core duty' within the Code, members are required to: 'treat people fairly regardless of: age, disability, gender reassignment, marriage and civil partnership, pregnancy and maternity, race, religion and belief, sex and sexual orientation'.



On the Web

Code of ethics: www.cii.co.uk/media/9223937/cii_code_of_ethics.pdf

As a companion to the Code, a Transparency Guide can be found at: bit.ly/3mRysid

The fair treatment of customers and particularly of vulnerable customers is a key focus for the market, the regulators and the CII. Use this link to review the FCA guidance:

www.fca.org.uk/publication/finalised-guidance/fg21-1.pdf



On the Web

This link takes you to the financial vulnerability task force resource library which is a useful source of information: www.fvtaskforce.com/resource-library



Activity

Broking management decision: The practicalities of fair treatment

What recommendations would you make to a commercial broker keen to install a process that ensures the fair treatment of their clients? What features might differentiate between types of client and the service they receive?



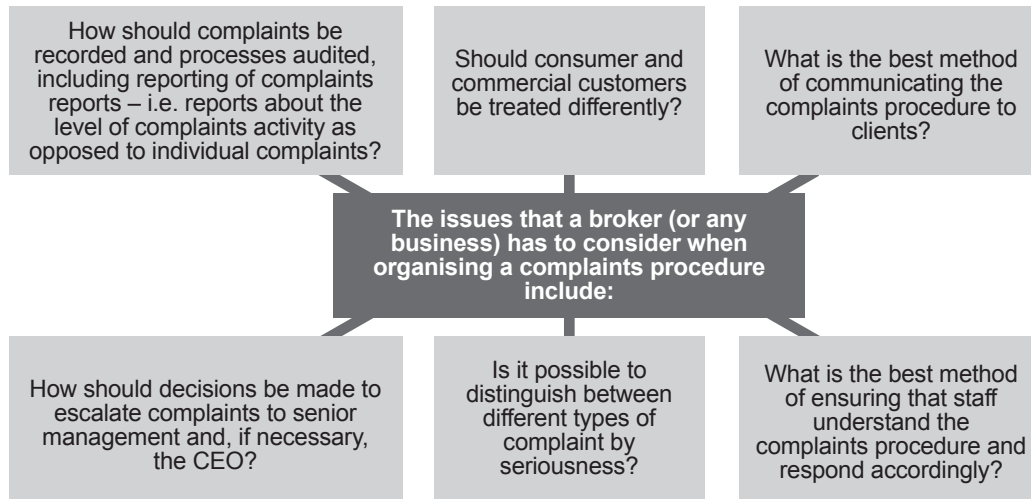
Critical reflection

Does the different treatment of customers, depending on whether they are consumers or commercial, maintain the standard of fair treatment of customers?

F Complaints

In the Disputes Resolution and Complaints sourcebook section of its Handbook, the FCA sets forth detailed rules concerning the procedures that brokers must adopt in order to ensure that **complaints** are dealt with fairly, in a timely fashion and to the satisfaction of the client. They also have to ensure that all staff understand the complaints procedure, the escalation process and the consequences if complaints are not dealt with effectively.

The rules are comprehensive and you are not expected to know them in detail.



There is a general view, supported by research, that where complaints are dealt with quickly and effectively the client is more likely to remain loyal. Conversely, where clients are dissatisfied with the complaints process, they are likely to leave.

The FCA wishes to see complaints acknowledged promptly and a final response given, where possible, within eight weeks of receipt. Consumers and small commercial customers must also be notified of their right (where applicable) to refer their complaint to the FOS within a period of six months, if they remain dissatisfied with the final response (or the lack of one after eight weeks).

Research exercise

Investigate research conducted on customer complaints and service issues to find the processes and companies that deal with complaints best. Does your firm employ similar methods? How do you think your firm would compare with those researched?



Critical reflection

Why does it make sense to have an effective complaints process irrespective of the requirements of regulation?



G Managing third parties

Historically, many individuals and businesses, arranged insurance through their agencies with insurers. There were also professional introducers known variously as 'half-commission men', 'agents' or more bluntly, 'fixers'. In the UK, their role was often to simply introduce business to a broker in return for a share of the brokerage. However, in many overseas locations, they might also be engaged in 'distributing' a share of the brokerage to other interested parties.

With the introduction of regulation to insurance intermediaries in 2005 any firm or individual engaged (however remotely) in insurance mediation as a business activity has to be fully authorised or has to have a valid exemption. This can be achieved by becoming an **appointed representative (AR)** or an **introducer appointed representative (IAR)**, of a broker that is authorised. Other valid exemptions have narrow eligibility criteria not relevant here.

G1 Appointed representative (AR)

An authorised broker proposing to sponsor an AR must first (before transacting any business):

- undertake a process of documented due diligence including examination of the AR's books;
- put in place a contract (with wording prescribed by the FCA);
- ensure the AR has effected adequate professional indemnity insurance; and
- obtain prior approval for the AR from the FCA.

The broker is wholly responsible for supervising its ARs (as though it was the FCA itself). Amongst other things, it must conduct regular compliance audits and have open access to the AR's books. Some firms within the same group have used this option as a cheaper, quicker and less bureaucratic alternative to applying for full authorisation, but generally the requirements have been considered onerous and it has not been a popular choice with many brokers.

Despite this, there are over 20,000 ARs that are able to carry out regulated activities under the supervision of an authorised insurer or broker acting as their principal. They include telephone sales agencies, retailers, travel agents and motor dealers who sell a wide range of insurance products including home, motor, travel, small business, warranty and guaranteed asset protection (GAP) products, primarily to consumer and small businesses.

An AR may only undertake the regulated activities for which its principal is authorised (has permissions). So, for instance, this is not a back door route for a firm to transact investment business by becoming an AR to a broker.

Under the FCA's ban on dual supervision, it is not permitted for an authorised firm to also become an AR of another firm, although a firm may be appointed an AR by more than one principal (in which case the principals must enter into an agreement to make clear which of them has prime responsibility for the ARs' supervision).

In 2016, the FCA took action against a number of principal firms after finding evidence of 'potential mis-selling and customer detriment'. It found some customers may have purchased products that they did not need or were not eligible to claim under, while some were not provided enough information by an AR (acting on behalf of an insurer or broker) to make an informed decision. This came from an in-depth analysis of the way in which AR relationships worked at a cross-section of 15 general insurance firms of varying sizes.

While some principals did have a good understanding of their ARs' activities and their obligations as principal firms, the FCA found widespread examples of poor practices across the sector. Action was taken against five of the unnamed firms and all firms received a written communication about their regulatory responsibility for the acts of their ARs.

Amendments to SUP 12 will be made to reflect requirements relating to the registration of ARs and continued oversight by principal firms. The amendments include a requirement on the principal firm to collect additional information from the AR in accordance with the registration requirements of the IDD.

On the Web

See the FSA factsheet for *Firms with appointed representatives* (Ref: SFDFS013 08/11) at:

www.fca.org.uk/publication/archive/fsa-responsibility-appointed-representatives.pdf.



G2 Introducer appointed representative (IAR)

An IAR must also be contractually bound to its principal and notified to the FCA (this can take place after the appointment), but the scope of regulated activity permitted is considerably limited by the rules that the necessary supervision is quite light.

The only activity an IAR is permitted to carry out is to communicate a provider's product details and to refer the (potential) customer's contact information to the broker. No advice may be given to customers under any circumstances and professional indemnity insurance is not a requirement. Given the lighter appointment and supervisory requirements this has been a well-used route, with some brokers and insurers having many IARs. Typical businesses are vets and property letting and managing agents.

Where an entity is restricted to merely displaying and providing a broker or insurer's product/service information (typically leaflets) this is not classed a regulated activity and no FCA appointment is required. However, the broker may use an appropriate Unregulated Introducer Agreement of its own design.

The Perimeter Guidance manual will be updated by the IDD to describe the broad new exclusion for firms which provide information about potential policyholders to insurers and brokers and for providing specified information to potential policyholders. This seems to cover the role of an IAR thus potentially obviating the need to make such appointments.

G3 Ancillary insurance intermediary

The IDD will also lead to a widening of regulatory scope to include all insurance distributors. This will see the introduction of a new category of intermediary, the ancillary insurance intermediary (All), where a somewhat lighter touch regime will apply, provided that:

- products do not cover life assurance or liability risks unless complementing what the intermediary provides as its principal professional activity;
- where the cover is for breakdown, loss of or damage to the goods, non-use of the service, damage to or loss of baggage, and other risks linked to travel (excluded from regulation altogether); and
- where the amount of the premium for the insurance product does not exceed €600 or €200 per person where the duration of the service does not exceed three months.

The FCA has established three categories of All:

- **In-scope AIs.** Firms which meet the definition of being an All and are within the UK's regulatory perimeter. This includes firms within scope of the Directive and firms such as motor vehicle dealers whose insurance distribution activities may be outside of the IDD but who are within the UK regulatory perimeter.
- **Connected travel insurance (CTI) providers.** Firms whose primary business is to make travel arrangements for customers, but who distribute insurance that is complementary to those services, such as travel agents, tour operators and airlines. The distribution of CTI contracts was brought into FSMA regulation subsequent to the IMD implementation and is currently subject to a different regulatory regime.
- **Out-of-scope AIs.** Firms outside the UK regulatory perimeter by virtue of the connected contracts exclusion (CCE) e.g. electronic goods and furniture retailers.

The FCA's regulatory approach will differ according to the category a firm falls into. In-scope AIs will be treated the same as brokers.

The FCA does not believe it would be appropriate or desirable that firms distributing through out-of-scope AIs could operate to different standards to those carrying out direct distribution activities. As such, authorised firms will be responsible for ensuring any out-of-scope AIs that they use comply with the same standards as brokers. The treatment will therefore be somewhat similar to that for ARs.



On the Web

See the factsheet for becoming an approved person for information on when an appointed representative is required to have an approved person(s) at:

www.fsa.gov.uk/pubs/other/factsheet_approved.pdf.

H Bribery Act 2010

The **Bribery Act 2010** repealed and replaced England's old laws on *bribery* with a new comprehensive anti-bribery code. Some legal commentators were very critical of the old laws on the grounds that they were confused and ineffective.

The need for reform was widely acknowledged by legal commentators and practitioners, although not necessarily from the firms and individuals that may be primarily affected by it. The Bribery Bill had cross-party support as it went through Parliament. However, the final result is not without controversy, mainly because of a certain lack of clarity as to what might actually constitute an offence.

There are four offences: the general offences of paying and receiving bribes (these are not dissimilar in substance to old law, albeit they introduce the concept of 'improper performance'), the bribery of foreign officials and the failure of commercial organisations to prevent bribery.

The corporate offence represents the most significant departure from the old law on bribery and will place the onus on the corporate to ensure that their anti-corruption procedures are robust.

Table 6.5: The four bribery offences

Paying bribes	It will be an offence to offer or give a financial or other advantage with the intention of inducing that person to perform a ' relevant function or activity '* ' improperly '†, or to reward that person for doing so.
Receiving bribes	It will be an offence to receive a financial or other advantage intending that a 'relevant function or activity' should be performed 'improperly' as a result.
Bribery of foreign public officials	This offence will be committed if a person offers or gives a financial or other advantage to a foreign public official with the intention of influencing the foreign public official and obtaining or retaining business where the foreign public official was neither permitted nor required by written law to be so influenced. This is a narrower test than the general offences, in particular given the 'business nexus' element. Given the extra-territorial provisions of the Act (see point 5), it is difficult to see what this offence adds to the general offences.
Failure of commercial organisations to prevent bribery (a new offence and the most controversial. It can only be committed by commercial organisations (companies and partnerships) in two circumstances)	A person associated with a relevant commercial organisation (which includes not only employees, but agents and external third parties) bribes another person (i.e. commits one of the offences above) intending to obtain or retain a business advantage. The organisation cannot show that it had adequate procedures in place to prevent bribes being paid.

This offence is intended to reverse the previous rules on corporate attribution in relation to bribery. Under the old law and under the new general offences for paying and receiving bribes, a commercial organisation's guilt requires the involvement of executive and board level management. Under this new corporate offence, the commercial organisation may be guilty even if no one within the company knew of the bribery.

The core defence requires the organisation to show that it had and has adequate procedures to prevent bribery. This introduces new pressure on businesses to ensure that their anti-corruption procedures are robust enough to stop bribery being committed by any employees, agents or other third parties acting on behalf of the business.

Table 6.6: Application and consequences of the new bribery offences

Extra-territoriality	All of the new offences will have extra-territorial application; namely, the offences may be prosecuted if committed by a British national or corporate or by a person who is ordinarily resident in the UK, regardless of whether the act or omission that forms part of the offence took place outside the UK. In addition, the corporate criminal offence will apply to commercial organisations that have a business presence in the UK (regardless of whether the bribe is paid in connection with that business).
Penalties	The Act will raise the maximum jail term for bribery by an individual from seven years to ten years. A company convicted of failing to prevent bribery could receive an unlimited fine.

The FSA began an investigation into the risks and procedures concerning bribery in commercial insurance brokers and published its findings in May 2010. Its key findings (paraphrased with the abbreviations: ABC=anti-bribery and corruption: BC=bribery and corruption) were:

Key findings

Although there were some examples of good practice, we identified a number of common concerns. These included:

- Weak governance of ABC efforts and a poor understanding of BC risk among senior managers.
- Failure to implement a risk-based approach to ABC in practice.
- Poor responses by many firms to significant BC events which should have led them to reassess the adequacy of their preventative systems and controls.
- Very weak due diligence on, and monitoring of, third party relationships and payments.
- Very little or no specific training was provided on ABC, even for staff in higher risk positions.
- Although payment authorisation controls appeared generally adequate, virtually no firms took steps to identify unusual payments to third parties. As a result, some firms failed to report suspicious activity until after our visit or follow-up work.
- Inadequate compliance and internal audit monitoring of ABC work.
- Weak vetting of staff compared with other financial sectors, with a heavier reliance on personal referrals and market gossip than usual.
- Although controls over staff expenses and accounts payable generally appeared to be effective, some firms gave large cash advances to staff to assist travelling in higher risk countries where they said credit cards were not readily accepted.
- Some firms awarded their brokers large bonuses directly related to the income or profit they generated. This could encourage risk-taking and negligence, and increase the risk of BC, particularly where brokers use third parties to win business.



As a result of these findings the FSA drew the following conclusions:

- 'We have concluded that broker firms have approached higher risk business involving third parties far too informally and many firms are still not operating at acceptable standards. These firms need to do more to ensure they minimise the risk of becoming involved in bribery or corruption, unwittingly or otherwise. At present, we judge that the serious weaknesses identified in some broker firms' systems and controls mean there is a significant risk of illicit payments or inducements being made to, or on behalf of, third parties to win business.
- We also believe that many firms are not currently in a position to demonstrate adequate procedures to prevent bribery – a defence to the Bribery Act 2010's new criminal offence of 'failing to prevent bribery'. However, we are encouraged by the progress of some broker firms over the past year in putting right weaknesses in their systems and controls, particularly through gap analysis against the interim findings of our review and the Final Notice we issued to Aon Ltd when we fined them in January 2009 for failing to establish and maintain effective anti-bribery systems and controls. We hope broker firms find the examples of good and poor practice in this document a useful tool for improving their systems and controls and raising awareness.'

The FSA then made a number of suggestions regarding good practice in their view that would enable firms to manage, mitigate and eliminate the risk of bribery:

- Management Information that enables management to assess, monitor and mitigate bribery and corruption risks with particular reference to higher risk third party payments, the control of introducers accounts, bank accounts and the like.
- Bribery and corruption risks must be evaluated as part of the firms overall risk management.
- Clear and documented responsibility for the function of monitoring and managing the bribery and corruption risk and ensuring this was understood by all relevant members of management.
- Additional vigilance in all dealing with 'high risk' countries using appropriate monitoring techniques.
- Rapid action upon the discovery of an incident that may indicate and increased or actual risk.
- Regular review of all business practice as it may affect the management of the bribery and corruption risk.
- Clarity within the firm over the definition of a third party. It suggests as a starting point that firms should regard all companies and/or individuals involved in insurance transactions who are not the underwriter or the insured to be third parties.
- Effective identification of 'high risk' third parties, for example those where there is an inadequate business case for the payment of commission.
- Documenting the reasons for all payments to third parties.
- Identifying connections between third parties and the insured or public officials.
- Applying appropriate procedures when acquiring other firms with arrangements with third parties.
- Identifying and documenting reasonable levels of commission.
- Robust procedures to confirm third party bank details.
- Appropriate and robust controls around payments.
- Robust recruitment procedures.
- Regular and effective training.
- Monitoring of the risks from remuneration.
- Effective suspicious activity reporting and whistle blowing procedures.



On the Web

Read the FSA's findings from its investigations into the risks and procedures concerning bribery in commercial insurance brokers at:

www.fsa.gov.uk/pubs/anti_bribery.pdf.

H1 Managing bribery and corruption risk

In November 2014 the FCA followed up the FSA's 2010 findings with a thematic review of small commercial insurance brokers' anti-bribery and corruption systems and controls (TR14/17 *Managing bribery and corruption risk in commercial insurance broking*). It found that most intermediaries it examined had begun to look at their relevant systems and controls, but it took the view it was still work in progress and needed more improvement.

The FCA's findings included the following:

- Most of the intermediaries seen were still not thought to be managing the risk effectively.
- Risk assessments were based on too narrow a range of risk factors and many intermediaries failed to take a holistic view of the risk associated with individual relationships.
- Half of the due diligence files reviewed were judged to be inadequate and senior management oversight often weak.

The findings were addressed by an update to the FCA's regulatory guidance document 'Financial crime: A guide for firms', and this took effect on 27 April 2015. Section 17 sets out guidance for managing bribery and corruption risk in commercial insurance broking with the

following noteworthy points. For brevity, the summary below covers only the mandatory ('must do') and advisory ('should do') categories.

Governance

Intermediaries may consider appointing an anti-bribery and corruption (ABC) officer with technical expertise and professional credibility within the intermediary. Intermediaries should also ensure that responsibility for oversight and management of third party introducers and other intermediaries is clearly allocated.

Risk assessment

Factors intermediaries should consider relating to business-wide risk assessments include:

- risks associated with the jurisdictions they do business in, the sectors they do business with and how they generate business;
- risks associated with insurance distribution chains, in particular where these are long – this includes taking steps to understand the risk associated with parties that are not immediate relationships, where these can be identified (such as introducers, sub-brokers, co-brokers, producing brokers, consultants, coverholders and agents); and
- risks arising from non-trading elements of the business, including staff recruitment and remuneration, corporate hospitality and charitable donations.

Examples of risk assessments and due diligence for individual relationships include:

- the role that the party performs in the distribution chain;
- the territory in which it is based or in which it does business;
- how much and how the party is remunerated for this work;
- the risk associated with the industry sector or class of business; and
- the governance and ownership of the third party, including any political or governmental connections.

Intermediaries should decide on the level of due diligence, and to whom it should apply, based on their assessment of risk associated with the relationship. This relationship may include other parties in the insurance chain and not just their immediate contact. Where it is not possible or feasible to conduct due diligence on other parties, intermediaries should consider alternative approaches, such as adjustments to the level of monitoring to identify unusual or suspicious payments.

Ongoing monitoring and reviews

Examples of ongoing monitoring and review for ABC purposes include:

- payment monitoring, including a review of payments to identify unusual or suspicious payments;
- refreshing due-diligence documentation;
- ensuring that the business rationale remains valid – this may include a review of third-party introducers' activities;
- re-scoring risk where necessary, including based on the outcome of internal or external reviews or audits;
- updating politically exposed person (PEP) screening, sanctions screening and adverse media screening; and
- taking a risk-based approach to ongoing monitoring measures applied to directors, controllers, ultimate beneficial owners and shareholders relevant to third-party relationships, which is consistent with the risk rating applied at the outset of a relationship.

Payment controls – insurance broking accounts

Intermediaries should set meaningful thresholds for gifts and hospitality that reflect business practice and help identify potentially corrupt actions. When determining whether a payment is appropriate, staff responsible for approving payments should consider whether the payment is in line with the approved scope of the third-party relationship.

Payment controls – accounts payable

Intermediaries should consider whether an absence of recorded gifts, entertainment, expenses and donations may be due to reporting thresholds being too high and/or staff being unaware of the requirement to report.

Training and awareness

Examples of initiatives to supplement ABC training and awareness include:

- creating a one-page memory aid for staff that lists key points on preventing financial crime and the whistleblowing process, to which staff could easily refer; and
- appointing a compliance expert within each business area who provides ABC advice to staff.

Conclusion

Firms face the challenge of not only complying with the Bribery Act itself but also the FCA's guidance. The FCA will use the Principles for Businesses, Threshold Condition 3 and SYSC to ensure that all broking firms implement processes and procedures to ensure compliance with the Act, even though it contains its own provisions and penalties.

In some cases, firms may simply decide that some sources of business present too much risk or are incapable of being subject to the new law.

As an example of its approach, in January 2009 the FSA fined Aon £5.25m for failing to take reasonable care to establish and maintain effective systems and controls to counter the risks of bribery and corruption associated with making payments to overseas firms and individuals.

According to the FSA, between 14 January 2005 and 30 September 2007, Aon failed to properly assess the risks involved in its dealings with overseas firms and individuals who helped it win business, and failed to implement effective controls to mitigate those risks. As a result of Aon's weak control environment, the firm made various suspicious payments, amounting to approximately US\$ 7m, to a number of overseas firms and individuals.

Between 2009 and 2014, a further three insurance brokers received substantial fines for failing to put in place adequate procedures to prevent bribery and corruption risks.



On the Web

You can read the complete Act at:

www.legislation.gov.uk/ukpga/2010/23/contents.



Activity

If you are a CII member, you can view a video on the Bribery Act 2010 on the CII website:

www.cii.co.uk/knowledge/claims/articles/the-bribery-act-explained-video/16593.

I Sanctions legislation

As we have seen from the subject of bribery above, the FCA can use its powers to influence the behaviour of firms. See the example below.



UK financial sanctions

This report sets out our findings of firms' performance in meeting our financial crime requirements in relation to UK financial *sanctions*. It does not report on firms' compliance with the UK financial sanctions regime: this is a matter for the government. Nor does it constitute formal guidance from the FSA. However, we expect firms to consider our findings and examples of good and poor practice and, where appropriate, to translate them into a more effective risk assessment and implement more effective systems and controls. As in any other area of their business, firms should take a proportionate, risk-based approach to preventing financial crime, including financial sanctions breaches by the firm. Small firms should consider the factsheet that we will make available on our website to help them comply with our requirements in relation to UK financial sanctions. We will advise small firms through our 'regulation round-up' email when this is available.

Source: Financial Services Authority (2009) *Financial services firms' approach to UK financial sanctions*. Available at:

www.fca.org.uk/publication/archive/fsa-sanctions-final-report.pdf.

The FSA reviewed the industry in 2009 'to assess current industry practice, identify examples of good and poor practice, and share our findings with the industry'. Its findings were that 'there are inadequacies in firms' systems and controls to reduce the risk of a breach of UK financial sanctions in all sizes of firms across all financial sectors.

Many firms need to enhance their systems and controls and small firms in particular should improve their awareness of the UK financial sanctions regime.'

At this stage you may be asking what this has to do with insurance brokers? While the incidence of financial crime in the UK may be small, the FCA (and the FSA before it) does take the issue very seriously. Look no further than the following.

FSA fines Royal Bank of Scotland Group £5.6m for UK sanctions controls failings

The Financial Services Authority (FSA) has today fined members of the Royal Bank of Scotland Group (RBSG) £5.6m for failing to have adequate systems and controls in place to prevent breaches of UK financial sanctions.

UK firms are prohibited from providing financial services to persons on the HM Treasury sanctions list. The **Money Laundering Regulations 2007** (the Regulations) require that firms maintain appropriate policies and procedures in order to prevent funds or financial services being made available to those on the sanctions list. During 2007, RBSG processed the largest volume of foreign payments of any UK financial institution. However, between 15 December 2007 and 31 December 2008, RBS Plc, NatWest, Ulster Bank and Coutts & Co, which are all members of RBSG, failed to adequately screen both their customers, and the payments they made and received, against the sanctions list. This resulted in an unacceptable risk that RBSG could have facilitated transactions involving sanctions targets, including terrorist financing.

The FSA considers that RBSG's failings in relation to its screening procedures were particularly serious because of the risk they posed to the integrity of the UK financial services sector. This is the biggest fine imposed by the FSA to date in pursuit of its financial crime objective. It is also the first fine imposed by the FSA under the Regulations.

Margaret Cole, FSA director of enforcement and financial crime, said:

The involvement of UK financial institutions in providing funds, economic resources or financial services to designated persons on the sanctions list undermines the integrity of the UK's financial services sector. By failing to screen relevant customers and payments against the HM Treasury sanctions list, RBSG left itself open to the risk that it was facilitating terrorist financing.

The scale of the fine shows how seriously the FSA takes this issue and should act as a warning to other firms to ensure that they have adequate screening procedures.

As RBSG agreed to settle at an early stage of the FSA investigation, it qualified for a 30% reduction in penalty. The FSA would have otherwise imposed a financial penalty of £8m.

Source: Financial Services Authority (2010) *FSA fines Royal Bank of Scotland Group £5.6m for UK sanctions controls failings*. Available at:

bit.ly/2A8gCPU.



You should note that RBSG was fined for failings in its systems, **not for any actual incident of financial crime**. The mere fact that there is a risk and that this risk is not addressed by a broker is enough to expose a broker to very severe penalties.

Sanctions usually involve a prohibition of providing financial services (including insurance) to those named on the sanctions lists.

Clearly, brokers must therefore take the sanctions legislation and the view of the FCA seriously.

Considerations will include:



Research exercise

Look at the sanctions law and regulations for the UK and compare it with the USA. What types of business and territories are likely to present the highest risk?



Broking management decision: Sanctions law

How would you evaluate a decision as to whether to stop trading with an individual or a territory in the light of sanctions law?

J Money laundering

The FCA has issued a regulatory guide for firms (available on its website) on reducing financial crime risks. This is achieved through a mixture of direct rules promulgated by the FCA and interaction with other legislation.

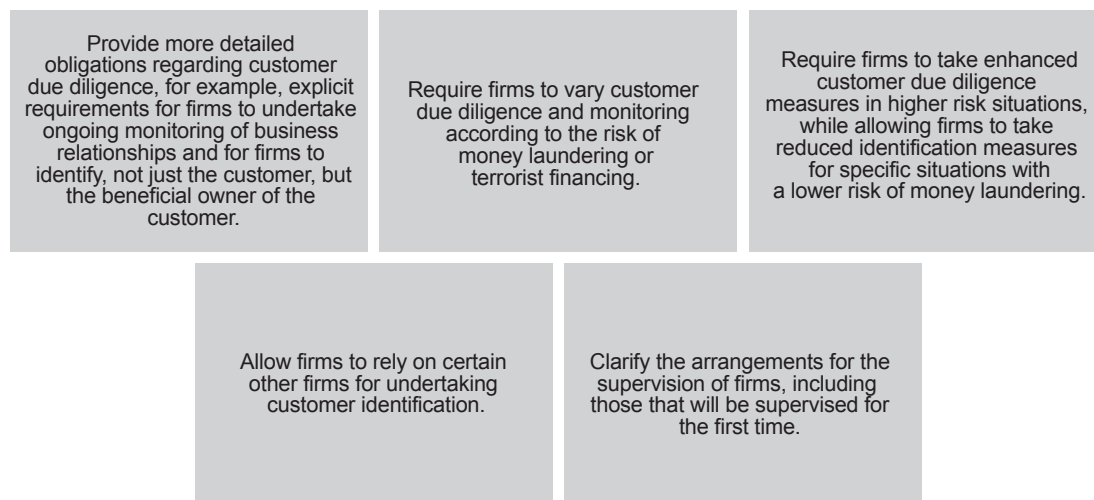
The **Proceeds of Crime Act 2002** and the **Terrorism Act 2000** provide the criminal offences of *money laundering* and terrorist financing. Firms and individuals who fail to report suspicions of money laundering or terrorist financing will face penalties, and where the risk is considered particularly high (not insurance intermediaries) the Money Laundering Regulations 2007 apply.

Table 6.7 lists the Handbook's SYSC rules.

Table 6.7: The FCA Handbook SYSC rules for money laundering

SYSC rule	Rubric
6.1.1	A firm must establish, implement and maintain adequate policies and procedures sufficient for countering the risk that the firm might be used to further financial crime.
6.3.1	A firm must ensure the policies and procedures established under SYSC 6.1.1 include systems and controls that: • enable it to identify, assess, monitor and manage money laundering risk; and • are comprehensive and proportionate to the nature, scale and complexity of its activities.
6.3.3	A firm must carry out a regular assessment of the adequacy of these systems and controls to ensure that they continue to comply with SYSC 6.3.1 R. The FCA, when considering whether a breach of its rules has occurred, will take account of whether a firm has followed the relevant provisions in the guidance issued by the Joint Money Laundering Steering Group. This group is not a body under the control of the FCA because its remit is industry-wide (including, e.g. estate agents) and not confined to financial services.
6.3.8	A firm must allocate to a director or senior manager (who may also be the money laundering reporting officer (MLRO)) overall responsibility within the firm for the establishment and maintenance of effective anti-money laundering systems and controls.
6.3.9	A firm (with the exception of a sole trader that does not employ any approved persons) must: • appoint an individual as MLRO, with responsibility for oversight of its compliance with the FCA's rules on systems and controls against money laundering; and • ensure that its MLRO has a level of authority and independence within the firm and sufficient access to resources and information to enable them to carry out that responsibility.

In summary the FCA's requirements are to:



Although general insurance is deemed to present a lower risk of money laundering than other types of financial services, it is not immune from the risk. Possible examples include:

- taking out a policy with a substantial premium that is paid for in cash and cancelled soon after;
- a client electronically transferring (into the broker's client money account) substantially more than they know is required to pay the premium – knowing that the broker will refund the difference; and
- a client making a substantial claim soon after inception.

The difficulty for brokers is that not all cases of the above examples will be suspicious. Some rural farming communities prefer to deal in cash, for example, or clients in overseas jurisdictions may face lengthy processes to get funds out of their country, so may have started the process long before the actual premium was calculated.



Broking management decision: New clients

What processes should be in place to determine that a new client is *bona fide* and not a proscribed person, and that the processes selected can be audited?

K Record keeping

SYSC rule 9.1.1 says:

A firm must arrange for orderly records to be kept of its business and internal organisation, including all services and transactions undertaken by it. These must be sufficient to enable the FCA to monitor the firm's compliance with the requirements under the regulatory system, and in particular to ascertain that the firm has complied with all obligations with respect to clients.

The first part of the rule means that the firm must maintain records that enable it to demonstrate its compliance with all aspects of the regulation. With respect to clients, there are further reasons why the firm needs to take care over **record keeping**:

- For Lloyd's brokers, there was once a bye-law that required slips, policies, endorsements and claims records to be kept for 80 years. While this was revoked leaving it did not mean that 80 years was not a meaningful standard for clients and the law.
- **Johnston v. Lesley and Godwin Financial Services (1995)** is the leading case on the broker's common-law duties to retain records. Details of business placed in 1956 were mislaid by the broker so that no evidence could be presented on which insurers were liable. The court found that the broker was liable to pay the proportion of the insured's claims that were collectible from solvent insurers. This case imposes a duty on the broker to retain records on behalf of a client 'so long as a reasonable broker would regard a claim as possible' even after the broker has ceased acting for the client. This means that record retention and destruction policies need to be reviewed in the light of prevailing claims trends. The current litigation over mesothelioma claims with their possible 40- and 50-year latency periods is an indication of how long records should be kept.
- As a matter of self-interest, the broker also needs to retain records in order to defend claims of negligence brought by past and present clients where the issue is not the retention of records, as in the Johnston case, but for poor advice for example.

According to SYSC 9.1.4 and 9.1.5:

- Records should be capable of being reproduced in the English language on paper. Where a firm is required to retain a record of a communication that was not made in the English language, it may retain it in that language. However, it should be able to provide a translation on request. If a firm's records relate to business carried on from an establishment outside the UK, an official language of that country or territory may be used instead.
- Firms should have appropriate systems and controls in place with respect to the adequacy of, access to and the security of its records so that the firm may fulfil its regulatory and statutory obligations. With respect to retention periods, the general principle is that records should be retained for as long as is relevant for the purposes for which they are made.

Brokers therefore need to give serious consideration to their procedures for the secure storage of records and of course whether old paper records should be kept or relevant documents transferred to electronic storage. While virtually every document today is probably originated electronically, the broker still needs to consider the security of the electronic storage method and the accessibility of the files, especially where they were created by long-departed staff or are password protected.

These are not trivial issues as the cost of paper storage is not cheap, nor is the cost of transferring paper records to electronic media. Even today, most firms will have surprising quantities of paper records.

K1 The Employers' Liability Tracing Office (ELTO) and the Employers' Liability Database (ELD)

In 1999, the Association of British Insurers (ABI) in conjunction with the Non Marine Association of Lloyd's published an Employers' Liability Code of Practice (ELCOP) for tracing past employers' liability (EL) insurance policies. Insurers and Lloyd's syndicates undertook to maintain records of all current and future policies in a form that facilitates ready searches, i.e. by name of employer and/or policyholder.

The ABI launched a policy tracing service which involved EL insurers voluntarily searching through many years of policy information in order to trace the actual policy.

Although improving, the success rate for this has not been as high as the EL insurance industry would like and a more effective tracing solution is needed for the future.

The ELTO is an independent industry body comprising members who underwrite EL insurance. Its purpose is to assist claimants, who have suffered injury or disease caused during their employment, to identify the EL insurer relevant to the period of employment. To achieve this goal the ELTO has created the Employers' Liability Database (ELD), which will contain the following records:

- Details of all new and renewed EL insurance policies, incepting on or after 1 April 2011.
- Old EL policies that have new claims recorded against them.
- Successful traces undertaken by its predecessor – the ABI tracing service.

On the Web

You can access the ELTO website at:

www.elto.org.uk/.



The FSA had published its regulations concerning its policy statement *Tracing employers' liability insurance* (PS11/4). It introduced regulations that require all EL insurers, including those in run-off, to publish EL policy data.

All EL insurers are required to publish data in a searchable format via their own website or become members of ELTO. Brokers are expected to comply with these regulations by, where necessary, submitting the relevant data about EL policies; a further reason to ensure that the broker has a robust record-retention procedure.

Changes to the rules in ICOBS 8 amending the strict requirement on insurers to collect employer reference numbers (ERNs) came into force on 1 October 2014. The new rules no longer require a firm to include an ERN on its employers' liability register when the failure to do so is solely because of failure by a third party outside the firm's control, and that the firm used 'best endeavours' to obtain the ERN.

On the Web

You can read the FSA's policy statement at:

www.fsa.gov.uk/pubs/policy/ps11_04.pdf.



L Competition law

The natural effort of every individual to better his own condition ... is so powerful a principle that it is alone, and without any assistance, not only capable of carrying on the society to wealth and prosperity, but of surmounting a hundred impertinent obstructions with which the folly of human laws too often encumbers its operations.

People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.

Source for both quotes: Adam Smith (1776) *An inquiry into the nature and causes of the wealth of nations*.



Two sets of competition rules apply in parallel in the UK. Anti-competitive behaviour that may affect trade within the UK is specifically prohibited by Chapters I and II of the **Competition Act 1998** and the **Enterprise Act 2002**.

Where the effect of anti-competitive behaviour extends beyond the UK to other EU Member States, it is prohibited by Articles 101 and 102 of the Treaty on the Functioning of the European Union (TFEU).

UK and EU competition law prohibit the following two main types of anti-competitive activity:

- Anti-competitive agreements, arrangements and concerted business practices that appreciably prevent, restrict or distort competition (or have the intention of doing so) and which affect trade in the UK or the EU, respectively (the Chapter I Competition Act 1998/Article 101 TFEU prohibitions).
- Abuse of dominant market position (under the Chapter II Competition Act 1998/Article 102 TFEU prohibitions); these prohibit businesses with significant market shares unfairly exploiting their strong market positions.

The Enterprise Act 2002 established the **Office of Fair Trading (OFT)**, the **Competition Appeal Tribunal (CAT)** and the **Competition Service (CS)**. Amongst other things, it created the offence for those entering into certain anti-competitive agreements and the disqualification of directors of companies engaging in certain anti-competitive practices.

The consequences of breaching these laws are severe; fines of up to 10% of group global turnover, disqualification of directors, criminal penalties and the possibility of actions for damages.

Whether or not an arrangement is anti-competitive is assessed on the basis of its objective, or its effect on competition, rather than its wording or form. This means that verbal and informal 'gentlemen's agreements' are equally capable of being found to be anti-competitive as formal, written agreements. Typical anti-competitive arrangements include those that directly or indirectly fix purchase or selling prices, or that restrict supply or prevent new competitors entering a market.

Cartel behaviour between competitors is the most serious form of anti-competitive behaviour under Chapter I/Article 101 and carries the highest penalties. A 'hardcore' cartel is one which involves price-fixing, market sharing, bid rigging or limiting the supply or production of goods or services. Individuals prosecuted for a cartel may be liable to imprisonment for up to five years and/or the imposition of unlimited fines.

The **Competition and Markets Authority (CMA)** became the primary regulatory body for competition law enforcement when it was created through the merger of the OFT with the Competition Commission. The formation of the CMA was enacted in Part 3 of the **Enterprise and Regulatory Reform Act 2013**.

Competition law is closely connected with law on deregulation of access to markets, state aids and subsidies, the privatisation of state owned assets and the establishment of independent sector regulators. Specific 'watchdog' agencies such as Ofgem, Ofcom and Ofwat are charged with seeing how the operation of those specific markets work. The OFT and the Competition Commission's work is generally confined to the rest.

L1 So what has this got to do with insurance?

Until April 2010 the insurance market was subject to what was known as an EU **Insurance Block Exemption Regulation (IBER)**. This covered four areas:

- The sharing of certain data between insurance companies.
- Co- and reinsurance pools and 'ad hoc' coinsurance and co(re)insurance.
- Standard non-binding policy conditions.
- Security devices.

Exemptions create a 'safe harbour' for insurers and brokers, which means that they cannot be prosecuted for a competition offence by engaging in these activities provided they stay within the rules of the exemption.

From April 2010 the IBER only applied to data sharing and some pools. Data sharing applies to, for example, agreements on joint compilations, tables and studies (typically agreements among companies to share access to statistical data). The European Commission

recognised the public benefit in allowing the exemption and saw the importance of protecting and facilitating cooperation in this area to allow the accurate calculation of risk.

The EU believed that from a competition perspective, co- and reinsurance pools could be problematic as they could restrict competition on price and cover terms.

The European Commission decided to retain the block exemption for pools that cover 'new risks'. Exactly what 'new' meant was left undefined, but suggests risks that the commercial market cannot or will not cover, such as epidemics. It also allowed other pools to continue, provided the pool participants do not exceed certain market share thresholds. An example of such a pool is British Nuclear Insurers.

Exemptions

Exemptions create a 'safe harbour' for insurers and brokers, meaning that they cannot be prosecuted for a competition offence by engaging in these activities provided they stay within the rules of the exemption.



The IBER no longer applies to agreements on standard non-binding policy conditions as the European Commission has taken the view that these generally do not give rise to competition issues and are not particular to the insurance industry. Similarly, agreements on minimum specifications for security devices will also lose the benefit of the block exemption, due to the increasing harmonisation of standards across the EU. However, the general principles of competition law will continue to apply to both these types of agreement.

The insurance market has a long tradition of cooperation between insurers and brokers on various technical issues, including the agreement of standard policy and endorsement wordings, particularly in the London Market. Indeed, the aviation market, for example, makes extensive use of standard wordings common to most of the participants in the market. This has the benefit of consistency and certainty but could be argued to reduce choice for clients. The response from insurers might be: 'Do you want to buy a £1,000,000,000 liability limit comprised of 50 or 100 different wordings?'

This means that whenever industry-wide meetings (whether involving insurers or brokers or both) take place, there has to be scrupulous observance of the competition law to ensure that no activity that would be deemed to be anti-competitive takes place. This requires all participants to state that they are not acting as a cartel and are free to act as they see fit.

Ad hoc co-insurance and co(re)insurance arrangements refer to the subscription arrangements typical of the London Market where a leader sets the terms and writes a percentage of the risk and then other insurers follow for their respective shares, normally at identical terms to the leader. These were specifically excluded from the scope of the IBER due to EU concerns over premium alignment, that is all subscribing insurers charge the same rate, and 'best terms' clauses.

The latter meant that if, say, the insurers writing 90% of the risk had agreed to do so at one rate but made their participation subject to 'best terms', if the last 10% was only available at a higher rate, then all the preceding insurers could benefit from the higher rate. 'Best terms' clauses have largely disappeared as they are regarded as in breach of general competition law.

To deal with the EU's concerns over premium alignment, the European Federation of Insurance Intermediaries (BIPAR) developed a set of high-level principles to govern subscription business placed by brokers:

- The intermediary shall, based on information provided, specify the demands and needs of the client as well as the underlying reasons for any advice.
- Before placing a risk, an intermediary will review and advise a client on market structures available to meet its needs and, in particular, the relative merits of a single insurer or a multiple insurer placement.
- If the client, on advice of the intermediary, instructs the latter to place the risk with multiple insurers, the intermediary will review, explain the relative merits and advise the client on a range of options for multiple insurer placement. Intermediaries will expect insurers to give careful independent consideration to the option requested.
- In the case of a placement of a risk with a lead insurer and following insurers on the same terms and conditions, the previously agreed premiums of the lead insurer and any

following insurers will not be aligned upwards should an additional follower require a higher premium to complete the risk placement. Indeed, the intermediary should not accept any condition whereby an insurer seeks to reserve to itself the right to increase the premium charged in such circumstances.

- During the placement of the risk, the intermediary will keep the client informed of progress. There are a range of options for multiple insurance placements. Two examples are:
 - selection of a lead insurer through a competitive process and subsequent invitation to potential following insurers to cover part of the risk on the same contract conditions and premium, it being understood that nothing should prevent following insurers quoting a different premium; and
 - selection of lead insurer through a competitive process followed by a series of negotiations between the broker and potential following insurers for the coverage of part of the client's risk not covered by the lead insurer with identical contract conditions and different premiums across all or some of the participating insurers.

L2 Achieving compliance

It is clear that in the light of the severe consequences of non-compliance, all brokers should regularly review whether their practices and agreements comply with competition law. For any broker, especially a broker with a significant share of the market in which it is active, it is vitally important to promote an understanding among employees as to what type of behaviour is and is not permissible under competition law. The practical ways this might be achieved could include:

- devising and implementing a competition compliance policy specifically tailored to the needs of the broking firm;
- implementing a training and education programme for all staff with a particular emphasis on senior and operational management; and
- devising specific protocols for the placement of co(re)insurance business that:
 - takes into account the needs of the client;
 - considers the merits of co(re)insurance agreements placed on the same terms, known as 'horizontal' placements, and those split with different terms (often known as vertical placements);
 - describes how the competition for leading underwriters is to be conducted;
 - considers the cost of the two methods of placement; and
 - reflects the specific training needs of staff.

Not only do such procedures minimise the risk of being non-compliant in the first place, but if a company is investigated for anti-competitive behaviour, evidence of a competition compliance policy may be taken into account by the Office of Fair Trading (OFT) and European Commission and could lead to a reduction in the fine imposed.

Since the broking profession is intensely competitive, it is unlikely that there will be issues arising from apparent anti-competitive collusion between firms. However, brokers need to be aware of competition issues that might arise from:

- market-wide committees;
- joint brokered accounts where, for example, one broker is performing programme design and another is providing global service;
- larger firms exercising undue power over insurers – e.g. Lloyd's receives nearly 50% of its premiums from the largest three brokers and those firms individually transact volumes in excess of \$1bn with major insurers; and
- restricted access schemes.

L3 FCA Competition Concurrent Regulation

In 2015 the FCA obtained 'concurrent competition' powers that gave it the authority to enforce the prohibitions on anti-competitive behaviour in the Competition Act 1998 and the Treaty on the Functioning of the European Union (TFEU) in relation to the provision of financial services. It was also given powers to carry out market studies, and make market

investigation references to the CMA under the Enterprise Act 2002, in relation to the provision of financial services in the UK.

These competition powers may also be exercised by the CMA with regard to financial services and other sectors of the economy. This means that, for financial services, the CMA and the FCA have 'concurrent powers' and the FCA is a 'concurrent regulator'. These powers are additional to the FCA's ability to use Financial Services and Markets Act 2000 powers in pursuit of its competition objective.

The overall aim is to benefit consumers of all types of financial services through detecting, enforcing against and deterring anti-competitive behaviour by firms. There have been examples of this in the insurance industry over time – most infamously by the Spitzer enquiry in the USA during 2004, which exposed bid rigging by several well-known international brokers based around contingent commissions on a grand scale.

Under policy statement *Competition Concurrence Guidance and Handbook Amendments* (PS15/18), the FCA set out its new powers and procedures under the Competition Act 1998 and for market studies and market investigation references.

At the same time, a new rule was introduced into the SUP section of its Handbook as the follows: 15.3.32 R (1): 'A firm must notify the FCA if it has or may have committed a significant infringement of any applicable competition law'.

In regard to what is meant by a significant infringement, SUP 15.3.34 states: 'In determining whether a matter is significant, a firm should have regard to the actual or potential effect on competition, any customer detriment, and the duration of any infringement and implications for the firm's systems and controls.'

M Whistleblowing

The FCA's new rules relating to whistleblowing, published in October 2015, do not directly apply to insurance intermediaries. However, the FCA has stated that for all firms not directly in scope, the text of the rules will act as non-binding guidance (i.e. 'should' rather than 'must', as, in fact, how much of the SYSC content applies to insurance intermediaries).

Firms were urged to comply in full by 7 September 2016, while the requirement to assign responsibilities to a whistleblowers' champion should have taken effect by 7 March 2016. This person will be responsible for overseeing the steps the firm takes to prepare for the new regime.

In practice, many broking firms will already have a written policy on whistleblowing in place for compliance with the **Public Interest Disclosure Act 1998**. This policy will be included in their Employee Handbook, where one exists, and the details of the procedures should not require major change in order to comply with the FCA guidance below.

The whistleblowers' champion:

- should have a level of authority and independence, and sufficient access to information and resources (including independent legal advice and training);
- need not have a day-to-day operational role handling disclosures from whistleblowers; and
- may be based anywhere provided they can perform their function effectively.

In addition to this appointment, the basic requirements are that firms should:

- have appropriate and effective arrangements for the disclosure of reportable concerns by whistleblowers, including where the whistleblower has requested confidentiality or has chosen not to reveal their identity;
- allow for disclosures to be made through a range of communication methods;
- ensure the effective assessment and escalation of reportable concerns by whistleblowers where appropriate, including to the FCA;
- include reasonable measures to ensure that if a reportable concern is made by a whistleblower, no person under the control of the firm engages in victimisation of that whistleblower;
- provide feedback to a whistleblower about a report they have made to the firm, where this is feasible and appropriate;

- maintain appropriate records of reportable concerns and their treatment including the outcome;
- maintain up-to-date written procedures that are readily available to employees outlining the firm's processes for compliance;
- prepare a report annually to the firm's governing body on the operation and effectiveness of its procedures, retaining the confidentiality of whistleblowers;
- report to the FCA any case contested, but lost before an employment tribunal, where the claimant successfully based all or part of their claim on either detriment suffered by making a protected disclosure or being unfairly dismissed; and
- arrange appropriate training for employees, managers and employees responsible for operating the firms' procedures.

Nothing prevents firms taking action against those who have made false and malicious disclosures.

N Scenario 6.1: Preventing financial crime

N1 Question

A recent section 166 investigation of your firm has indicated that it has inadequate procedures to monitor and prevent the risk of financial crime. You have been given responsibility for preparing a briefing to senior management colleagues that describes the issues and proposes measures to rectify the problem. Describe the key components of your presentation.

N2 How to approach your answer

Key points of content

You should aim to include the following key points of content:

The relevant aspects of the regulation and the law are:

- The Proceeds of Crime Act 2002.
- The Terrorism Act 2000.
- The Money Laundering regulations (although they do not apply to insurance brokers).
- The Bribery Act 2010.
- The FCA and PRA regulation:
 - Principle for Business 1 requiring a firm to act with integrity.
 - Principle for Business 2 requiring a firm to conduct its business with due skill, and care and diligence.
 - Principle for Business 3 regarding adequate controls.
 - Threshold condition 4.
 - Full Handbook SYSC rules that incorporate aspects of the Money Laundering rules into the regulation.
 - Full Handbook SYSC rules that require the firm to maintain adequate systems and controls.
- Sanctions regulations issued from time to time including prohibitions on trade with certain countries.
- All of these contain severe penalties including prosecution of the firm and individual Authorised Persons including fines and imprisonment.

Significant fines have been levied against Aon for Bribery issues and Royal Bank of Scotland for money laundering and sanctions compliance issues.

Although there is no evidence of actual wrong doing on our part, we can also be fined for systems and procedures that are deemed to be inadequate as allegedly have been revealed by our Section 166 investigation.

We therefore need to do the following:

- Urgently review our ability to comply with and implement the section 166 requirements.
- Review our procedures for complying with the Bribery Act including a review of our payments to third parties.
- Review the value of our dealings with countries subject to sanctions action by the government.
- Devise and implement as quickly as possible training for all staff with respect to the prevention of financial crime.
- Add financial crime to our risk management procedures and our risk register.
- Review and amend our management information and reporting procedures as they apply to the risks of financial crime.

Self-test questions

1. Summarise three of the key issues for a broker with respect to the compliance function.
2. What are the principals' responsibilities with respect to an appointed representative?
3. What type of activity would a company need to be undertaking to be exempt from regulated activities?
4. Regulated companies that use an Introducer should have a contract in place; what agreement would suit this need?
5. Provide a summary of four of the suggestions for good practice in the prevention of bribery and corruption.
6. What are the practical ways a broker may ensure that employees understand the need to comply with competition law?

You will find the answers at the back of the book

7

Legal structure insurance organisations and corporate risk management

Contents	Syllabus learning outcomes
Introduction	
A Legal structure of insurance organisations	3.1, 3.2
B Corporate risk management	3.5
C Scenario 7.1: Corporate risk management	
Self-test questions	

This chapter relates to **syllabus section 3**.

Learning objectives

On completion of this chapter and your own private research, you should be able to:

- analyse typical management structures; and
- examine the role of corporate risk management within insurance brokers.

Introduction



No institution can possibly survive if it needs geniuses or supermen to manage it. It must be organised in such a way as to be able to get along under a leadership composed of average human beings.

Source: Peter Drucker

In this and subsequent chapters, we do not attempt to emulate the many hundreds of texts on management and business organisation. For candidates that aspire to senior management roles, there is a suggested short reading list at the end of this chapter.

The list is not an ideal as there are as many opinions about management as there are about economics and the weather. Some have stood the test of time. Others just reflect your author's prejudices. Management texts are often fad driven and ephemeral and you need to be careful in your selection.

However some common themes emerge:

- Some of these books were published over ten years ago – even in the age of the internet, sound management principles hold true for the long term.
- There is no instant fix – the firm must have a clear strategy, communicated well to staff and clients, and subject to robust execution.
- What works in one business may not work in another – quality systems and Business Process Re-engineering (BPR) are examples from the 1990s that produced outstanding results for some firms and abysmal failure in others (quality systems are examined in chapter 13).
- The job of the chief executive is to get the strategy right, pick the senior team and watch the cash – a business that cannot pay its bills will struggle no matter how brilliant its strategy, execution and innovation.
- All businesses face 'headwinds'; negative forces such as increased regulation, competitor activity, changes in client and customer needs and wants, inflation and so on. If the firm does not respond to these challenges, it will shrink and eventually die.

In this chapter we consider the legal structure of insurance organisations and the role corporate risk management plays.



Key terms

This chapter features explanations of the following terms and concepts:

Authority, responsibility and accountability	Comply or explain	Composition of the board	Executive directors
Joint stock company	Non-executive directors	Public limited companies	UK Corporate Governance Code

A Legal structure of insurance organisations

The *joint stock company* was one of the key developments of the Victorian age. Before then, most businesses were run as partnerships or by sole traders with unlimited liability for the obligations of the business. The partnership structure survived for many firms of accountants, lawyers and other professionals although the majority if not all have converted to what are known as limited liability partnerships, mainly as a measure to offer the partners protection against litigation for negligence.

The joint stock company structure allowed investment by individuals whose liability was limited to the value of their shares. Although there have been many changes in the law regulating limited companies, this Victorian creation is the basis for many modern businesses.

Research exercise

Research the developments of the joint stock company and the impact it has had on business.



Numerically, the vast majority (over 99%) of brokers are private limited companies. This means that the shares in the business are not traded on a public exchange such as the London Stock Exchange (LSE). As a result, although they have to comply with the financial reporting and general conduct requirements of the **Companies Act 2006**, they are subject to less public reporting and governance requirements.

There are two types of private company, those limited by shares and those limited by guarantee. The benefit of being a limited company is that the assets and liabilities of the business are separated from the personal assets of the shareholders.

Public limited companies (PLCs) are companies registered under the **Companies Act 1980**. Their shares are listed on a public exchange such as the London Stock Exchange (LSE) or the New York Stock Exchange (NYSE). Aon, Marsh and Arthur J. Gallagher are listed on the NYSE; JLT is listed on the LSE and Willis Towers Watson commenced trading on the NASDAQ Stock Market following the merger of Willis and Tower Watson.

All companies with a premium listing are also required to comply with the **UK Corporate Governance Code**. While the Code, therefore, does not apply to the vast majority of insurance brokers, it is a principles-based approach and as such its provisions provide a good framework to examine the way limited companies should be run.

'Comply or explain' principle

Where a company determines that applying the Code is not appropriate or there is a better alternative it must explain its reasoning to its shareholders.

A condition of not complying with the Code is that the reasons for it should be explained clearly and carefully to shareholders – the 'comply or explain' principle.

A1 Directors and the composition of the board

Directors of a limited company are appointed by the shareholders to act as the agents and trustees of the company to look after their interests. The directors then form a **board of directors** and elect one of their members to be **chairperson**. The prime duty of the chairperson is to ensure meetings are properly and efficiently conducted. In addition, the chairperson is often the figurehead representing the company and its board to the outside world.

In addition to the leadership of the board, the chairman is also ultimately responsible for the hiring, appraisal and, if necessary, firing of the chief executive, although in most circumstances, the chairman would only take such extreme action after consultation with the rest of the board.

There are two different types of directors:

Executive directors: work full-time in the company and are given management responsibility for running the business. The board usually appoints one of the executive directors to be accountable for the running of the company on a day-to-day basis. This person is variously known as the **chief executive officer (CEO)** or managing director. The rest of the executive is selected and appointed by the CEO and the board. Large public companies normally have nominations committees to oversee this function.

Non-executive directors: are part-time appointments selected for the expertise they bring to the board. They do not perform an executive management role in the company. However, they attend board meetings and may be members of sub-committees in order to provide an independent view on matters such as audit, management remuneration and risk management.

It is conventional for the chairman to be a non-executive director, although some firms do have an executive chairman. In the light of the different responsibilities of the chairman and the CEO, the potential for a clash when both have executive status is obvious.

The same person may take the position of chairman and CEO but this is now rare in the UK under the current approach to corporate governance. The two positions perform significantly different functions, which do not sit logically together – after all, the chairman is responsible

for appraising the CEO's performance. Indeed, in many jurisdictions including the UK, corporate governance practice effectively forbids the merging of the roles of chairman and the CEO. However, in the USA, these roles are often held by the same person.

In January 2003, the Higgs report *Review of the role and effectiveness of non-executive directors* described the role of senior independent director (SID) as being 'available to shareholders if they have reason for concern that contact through the normal channels of chairman and chief executive has failed to resolve.

The SID should also chair meetings between the non-executive directors where the chairman does not attend'. Higgs also highlighted that SIDs must meet a test of independence. Since the publication of this report, the majority of FTSE 350 companies in Britain have appointed a senior independent director from the non-executives.

Since 2008, it has not been necessary for private limited companies to appoint a **company secretary** although many still do. For public limited companies, the appointment of a company secretary remains mandatory. The company secretary usually acts as the chief administrative officer of the company, leaving the directors free to concentrate on running the business. The company secretary doesn't have to be a director, but they do share some of the directors' legal responsibilities. However, ultimate responsibility for ensuring the company is properly administered remains with the directors.

In the UK both executive and non-executive directors of brokers must be approved persons and are subject to the Senior Managers & Certification Regime (SM&CR) under FCA regulation. In many brokers, it is common for many roles to be given the courtesy title 'director' (such as 'broking director' or 'client service director') even 'managing director', but unless they are actually appointed to the board by the shareholders and registered under Companies House, they are not legally directors. Refer to [Approved persons and the fit and proper test](#) on page 5/25 for more on approved persons.



Be aware

The approved persons regime has now been replaced by the Senior Managers and Certification Regime (SM&CR). See [Fit and proper test](#) on page 5/28, for more information.



On the Web

The UK Corporate Governance Code has much to say on the role of directors and leadership. To read the Code in full, visit:

bit.ly/2iWiwtr.



Company meetings

1. Board meetings

Board meetings are held periodically (depending on workload). In a plc, they normally occur on a monthly basis. Meetings of sub-committees of the board are also held from time to time, e.g. audit, remuneration, and risk committees.

2. General meeting of shareholders

Each year there must be at least one meeting of the shareholders – the annual general meeting (AGM) (although this is no longer a requirement for private companies). This would normally be presided over by the chairman, with the full board in attendance ready to answer questions. At an AGM, the standard agenda items usually include:

- Approval of the directors' report and accounts for the year.
- Declaration of dividend.
- Election of directors.
- Remuneration of directors.
- Appointment of the auditor.

If a company needs to pass special and urgent resolutions at other times of the year it will hold an extraordinary general meeting (EGM). This might be used, for example, to change the Articles of Association, to gain approval for a new share issue, or to proceed with a major acquisition.

A general meeting of a plc is often a very high profile event attended by the media, institutional shareholders and business analysts. It is also an opportunity for the company's performance and future plans to be challenged and shareholders to vote on major issues including, potentially, the removal of the Board. It is an occasion when the individual shareholder may stand up and publicly voice a complaint.

Source: Chartered Insurance Institute (2017) *990: Insurance corporate management*. London: Chartered Insurance Institute.

On the Web

Visit the Institute of Directors website and search for 'being a director':

www.iod.com.



A2 The executive and other key management positions

While the board is the main forum for making important and strategic decisions, the management of the delivery of business objectives is delegated to the CEO and the executive management team. This may meet weekly, calling itself the executive committee, management board or some similar title.

The diverse nature of senior executive roles is described below:

The chief finance officer (CFO) or finance director: is always a board-level appointment. The CFO is responsible for all financial matters including budgeting, financial planning and tax, and is often regarded as the next most senior position to the CEO. The CFO would normally be a qualified accountant.

This role includes the management of the financial risks to the company, financial planning and reporting, capital management, record keeping, taxation, and communicating the financial performance and forecasts to analysts. When necessary, the CFO may be involved in raising capital and in the acquisition or disposal of parts of the business.

Chief operating officer (COO): in some companies the board may take the view that the organisation is so large and complex that the role of the CEO should be split between two individuals.

The senior position, occupied by the CEO, would concentrate on long-term and strategic matters supported by a chief operating officer (COO) who takes responsibility for the day-to-day activities and operations management. Clearly the balance of responsibilities between these two roles may vary between companies. Often the CEO and COO will have contrasting personalities and skill sets.

Divisional or strategic business unit CEOs: are normally the leaders of the key business units generating the majority of revenue or profit.

Chief risk officer (CRO): is a newer role that would normally report through the CEO, CFO or company secretary, although it is now emerging as a specific board-level discipline in its own right.

The CRO is responsible for the coordination and management of the business-wide processes to identify, manage, monitor and report on the risks faced by the organisation. They may also have responsibility for compliance with corporate governance risk management rules and with regulatory and legal risk management and insurance requirements. The CRO would help the board establish risk management policy and provide education and support for management in implementing effective risk management processes.

Head of internal audit: is a member of senior management, usually reporting directly to the CEO.

Internal auditors are responsible for the independent inspection and assessment of the effectiveness of the range of risk management and internal control processes established by

management to manage risk across the organisation. They provide consultancy and advice on the adequacy of risk identification and assessment processes and the design of effective internal controls. They report on the overall adequacy of internal controls operated to enable the board to meet external reporting obligations. They are different from the external auditor, which is appointed by the board to audit the business and report to the shareholders.

Marketing director: this role depends very much on the nature of the business, i.e. whether it is centralised or not and its style of management. Marketing-led companies would normally have this role at board level. In addition to setting the marketing strategy, this role is responsible for marketing analysis, brand management and promotion. In some companies the marketing director is also responsible for the management of the sales function.



Marketing

Marketing is a process that identifies, anticipates and advances value propositions that satisfy customer needs in a profitable manner.

Human resources (HR) director: is responsible for the effective use of human resources in the workplace. This involves the development and implementation of policies for human resource planning, recruitment and selection, performance management, rewards and recognition, equality and diversity policies.

Information technology director or, more fashionably, the chief information officer (CIO): is responsible for the delivery of effective and efficient technology, essential to any organisation. This might include linking together voice, data and image across a whole range of platforms (telephony, desktop PCs/laptops, networks, servers, mainframes, communications processors, data storage media, display and print devices etc.) and connecting the technology across multiple sites, with third parties and the internet.

Strategy director: An integral part of the management role is each manager's responsibility for the development and implementation of plans in their units; the strategy director's job is to support the board and executive management in the creation of a company-wide strategic framework and also to establish a planning process to ensure that units present sound, deliverable plans that are consistent with that framework.

The strategy director would be expected to brief the management on strategic issues, facilitate planning meetings, and monitor the implementation of plans, probably by means of a balanced scorecard system. They would work closely with the CFO who has responsibility for the financial aspects of plans and budgets.



Research exercise

Using the internet, look at the board structure of a selection of UK, European and US companies to see how different countries organise the functions of the board and senior management.

A3 Authority, responsibility and accountability

In order to fully understand management roles it is necessary to appreciate the distinction between the concepts of authority, responsibility and accountability.

The ultimate **authority** (i.e. freedom to act) in a company is vested in the shareholders. Within legal constraints they can do whatever they wish with their company.

In practice they delegate the day-to-day exercise of that authority to the board of directors. The board in turn selects a CEO to be responsible for the running of the company, and the CEO, in consultation with the board, in turn appoints the senior management. They appoint their subordinates and assign the tasks for which they become **responsible**, i.e. have a duty to carry out.

This process cascades down to the most junior employee. In this way a line of authority to make decisions and carry out actions on behalf of the company stretches from the shareholders all the way down through the organisation. Once someone has accepted responsibility for a task they become **accountable** to the person who assigned it to them, i.e. they are required to report and explain their performance. It should be noted that authority can be delegated to someone further down the line but responsibility cannot.

For example, if an account is lost as a result of poor service, the person responsible for the account cannot simply try and shift the blame to others. They are responsible and remunerated for account retention and must be accountable.

Critical reflection

In your own business is there clarity of authority, responsibility and accountability? Do you take responsibility for the actions of others and how do you manage when something goes wrong?



B Corporate risk management

Here we are concerned with all of the risks that may affect the business as a whole rather than risks that can be insured. The 2008 financial crisis, the Eurozone crisis, the UK vote to leave the EU and events such as the security issues that befell G4S at the London Olympics are examples of external risks. Internal risks can include under-resourcing to save money, poor staff training or IT projects that go over budget.

It is a specific requirement of the FCA under Principles for Businesses (PRIN) 3 and SYSC 3 that insurance brokers have to make appropriate arrangements for the identification and management of risk. The FCA are now more concerned than ever about the approach a firm adopts to risk management. See chapter 5 for more on the Principles for Businesses and SYSC.

In response to changing views of risk in corporate UK, particularly the issue of the 'velocity of risk', the speed at which bad news can spread and a company's reputation be impaired or destroyed, the Financial Reporting Council conducted a series of meetings with senior executives to learn how boards were approaching their responsibilities in rapidly changing markets.

The report (*Boards and risk: a summary of discussions with companies, investors and advisers*) drew three main conclusions:

- Boards were focusing more on risk.
- The Turnbull Guidance was still seen as effective, but it needed to be updated to reflect the board's responsibilities under the UK Corporate Governance Code.
- Different boards used different techniques and structures and these should be shared more widely.

UK Corporate Governance Code

The UK Corporate Governance Code is subject to ongoing review. The latest report from October 2018 is available at:

bit.ly/2SfRcGt.



Again, while the report is concerned with listed companies, its message is applicable to all businesses large and small. It recognised that there is no one approach to risk management. What is appropriate for a global oil business would be completely excessive for a community insurance broker. What follows is a brief summary of the relevant process.

On the Web

Anthony Hilton's article for the *London Evening Standard*, 'Getting to grips with a new type of risk' indicates the real challenges of effective corporate enterprise risk management:

www.standard.co.uk/business/getting-to-grips-with-a-new-type-of-risk-6443390.html.



B1 Risk identification

The first step is to select a method to identify risks to the business. In theory, the process is straightforward. Depending upon the size and geographic scope of the firm there could be:

- a discussion at board level that may be facilitated with external assistance;
- similar discussions at divisional level; or
- an exercise conducted by external consultants.

Opinions vary as to how this work should be done. Some firms prefer to keep it entirely in-house whereas others choose to use external consultants. Some appoint a risk committee whereas others feel this is either a board-level responsibility or delegate it to the audit committee. As we have already seen, some larger businesses, appoint chief risk officers to manage this process.

The challenge in this process is to get an honest appraisal of the real risks, internal and external, faced by the business. This is a challenge that Paul Moore feels can be thwarted by the company culture. Few firms, at least until it is too late, will describe risks that are inherent in a particular strategy because it is considered 'politically incorrect' to criticise.



Research exercise

Examine a variety of reports and accounts of larger public companies to see how different companies describe risks and how they deal with them. Look also for summaries of the top ten risks and how they have changed over time. Simply type 'top ten risks for business' into your search engine. An example from the Ernst & Young business risk report 2010 can be found at:

www.globalnegotiator.com/files/Risks-in-International-Business.pdf.

1. Regulation and compliance.
2. Access to credit.
3. Slow recovery or double dip recession.
4. Managing talent.
5. Emerging markets.
6. Cost cutting.
7. Non traditional entrants.
8. Radical greening.
9. Social acceptance and corporate social responsibility.
10. Executing alliances and transactions.

Are any of the risks you have identified relevant to insurance brokers? If not, can you think of examples that are? A few suggestions are provided below. Can you recognise any of the processes used within your own firm?

Some examples of the risks that may affect brokers of all sizes include:

- action by regulators, including a section 166 investigation;
- failure of an insurer; and
- an arbitrary reduction in commission rates by insurers.



Broking management decision: Managing risks

Imagine you are a senior director in a broking firm that has recently conducted a risk identification exercise. Select three of the possible risks and consider how the firm would plan for and mitigate them.

B2 Risk analysis

As risks are identified they are scored as to probability and severity. Most firms tend to stick to 'low, medium and high' in recognition of the difficulty in ascribing exact quantities to many risks. However, some firms attempt more precise scoring on say a 1–10 scale.

In some cases the firm may need to do further work to establish the relevant scoring for a given risk. For example, the political risk of a coup in a key country, or the earthquake or flood risks to a data centre based in, say, India or the Philippines.

Once this process is complete, the risks can be summarised graphically in a number of ways. Appendix 7.1 shows an example kindly provided by Willis, with a record of the threat assessment and categorisation that, in many businesses, will be known as the 'risk register'. You can find this on RevisionMate.

Figure 7.1 provides an example of 'risk tolerance' or 'categorisation', also with the kind permission from Willis.

Figure 7.1: Risk tolerance guidewords

Use these guidewords to rank risks for risk improvement action

Unacceptable	• Most concerning • Controls are insufficient or ineffective • Irrecoverable damage to reputation, finances or business continuity • Action required immediately • Funds must be made available • Status of risk requires urgent and decisive action
Severe	• Concerning • Controls in place but may be ineffective • Contingency plans should overcome worst results • Some action required immediately/further action at a later date • Status of risk should be managed continuously
Material	• Causes unease • Controls in place which address causes of risk • Existing contingency plans can manage the consequences • Action plans should be prepared later if required • If necessary, budget funds should be identified • Status of risk should be monitored continuously
Controlled	• Comfortable with the risk • Controls are sufficient and already in place • Consequences can be managed or are relatively unimportant • Issues of continuous under-performance should be budgeted for • Status of risk should be reviewed from time to time

It should be recognised that this is just one approach. Many risks are difficult to quantify and equally, the tolerance of risk will be very variable depending upon its nature.

B3 Treatment of risk

The next step is to decide what to do about each of the risks identified. This should include:

- who within the organisation takes responsibility for the risk – most firms tend to allocate risks to the person in the best position to manage and monitor them with the proviso that some risks must remain the province of the executive management group;
- the structure of the overall management of the process via board committees and sub-committees – some firms appoint a specific risk committee;
- clear protocols to ensure clarity of ownership of risk to avoid a risk ‘falling between the cracks’; and
- the regularity of review.

There are rarely simple answers to the way risks are treated. The FRC review says specifically that businesses are in the business of taking risks. In an uncertain world, the most effective approach might take the form of well-prepared crisis plans rather than elimination or mitigation.

However, elimination should be considered. For example, the risk of bribery and corruption is considered to be much higher in some countries than in the UK. A broker might therefore decide that in some territories, the risks cannot be managed or mitigated and should be eliminated by ceasing to trade there.

In chapters 5 and 6 you will have found how important the FCA regards transparency and conflicts of interest. In 2009–10, in the wake of the financial crisis, the signs seemed to be pointing to mandatory commission disclosure becoming a reality and thus the risk of a sudden change in the regulation could have been seen as, for example, medium probability and medium-to-high severity. Yet to date the rules have not changed. However, this still remains a sensitive subject and there is no doubt that things will have to change.

As James Dalton of the ABI said: 'it is only a matter of time before the FCA starts asking questions about the transparency of broker commission' (*Insurance Age*, 8 June 2016). The introduction of the **Insurance Distribution Directive 2016/97/EC (IDD)** has led to a review, and provided guidance and rules on the disclosure of remuneration. The review had proposed what is in effect mandatory disclosure of all broker earnings, by whatever method. However, following extensive consultation and lobbying of the EU, it has fallen short of mandatory disclosure.



Critical reflection

Consider the risks that your own firm faces and whether they should be managed, mitigated or eliminated.

B4 British Standard: Risk Management Code of Practice

There are various frameworks for the Risk Management Code of Practice. The BS31100, which is not compulsory, is recognised as current best practice. A detailed knowledge of the code is not required for this course. However, it sets the following key principles:

- Risk management comprises a process and a framework that enables a business to manage uncertainty in an effective, efficient and systematic way at all levels.
- The approach should be proportionate and adapted to the size and nature of the business. Managing risk within the energy division of a global broker is clearly different to the risks presented by a firm staffed by five people.



On the Web

Visit the Airmic website and search for 'Risk Management Standard':

www.airmic.com.



Additional reading

Management and economics texts

There are thousands of management texts, some of which have sold in the millions. This is a small selection made by the author. They are not essential for this course but for candidates with ambition, they are a good place to start to expand your knowledge. Candidates are advised to read a wide selection of reviews first. They are not in a preferred order.

Carnegie, D. (1981) *How to win friends and influence people*. Simon & Schuster (First published in 1936.)

An enduring bestseller that has sold more than 30m copies. Carnegie advises that 'when dealing with people, remember you are not dealing with creatures of logic, but with creatures of emotion, creatures bristling with prejudice, and motivated by pride and vanity.' He argues that success is only 15% professional knowledge; the remaining 85% is 'the ability to express ideas, to assume leadership, and to arouse enthusiasm among people.'

Conway, E. (2011) *50 economics ideas you really need to know*. Quercus. (First published in 2009.)

A primer on some of the key economics ideas ranging from 'the invisible hand' of Adam Smith to Schumpeter's Creative Destruction.

Deming, W. E. (2000) *Out of the crisis*. MIT Press. (First published in 1982.)

This classic on quality management reflects Deming's experience of introducing statistical methods for quality measurement and improvement to Japan in the 1960s. Aiming to transform the US style of management and governmental relations with industry, the author blends statistics and common sense to challenge American business practices at almost every point, launching the quality revolution here. Citing poor management, not lazy workers, as responsible for most quality problems, this book, in simple, direct language, offers a theory of management based on Deming's notable 14 Points of Management, and explains how to apply them to boost quality.

Drucker, P. F. (2007) *The practice of management*. Elsevier. (First published in 1954.)

Considered the foremost management and business thinker of the 20th century, Drucker was the first to depict management as a distinct function, a separate responsibility in the workplace: the work of getting work done through and with other people. This still-relevant book holds that management was one of the major social innovations of the last century, and it poses three now-classic business questions: What is our business? Who is our customer? What does our customer consider valuable?

Hammer, M. and Champy, J. (2009) *Reengineering the corporation: a manifesto for business revolution*. Nicholas Brealey Publishing (First published in 1993.)

Though based on the relatively dry field of operations research, this book became a prominent bestseller in its heyday, replacing much of the received wisdom of the last 200 years of industrial management with a radical prescription for rebuilding businesses wholesale to achieve dramatic performance gains.

Unfortunately, this pioneering book garnered some controversy, largely because corporate cost-cutters used the concept of re-engineering to justify mass layoffs. Acknowledging that re-engineering can be difficult to launch and to sustain, the authors provide clear and specific guidelines, numerous examples, and in-depth case studies.

Jay, A. (1994) *Management by Machiavelli*. Pfeiffer. (First published in 1967.)

Anthony Jay was the co-writer of *Yes, Minister* and *Yes, Prime Minister*. His insights are still valid, particularly for larger companies where 'barons' compete for dominance against 'the prince', demonstrating how the political realities of management 'power' can upset any thoughtful management strategy.

Peters, T. J. and Waterman, R. H. (2015) *In search of excellence: lessons from America's best-run companies*. Profile Books. (First published in 1982.)

A highly influential and classic text, dealing with the impact of global competition, largely from Japan. Based upon in-depth interviews with over 40 manufacturing companies, the book looks for the core principles that make businesses successful.

Porter, M. E. (1998) *Competitive strategy: techniques for analyzing industries and competitors*. The Free Press. (First published in 1980.)

Another management classic that continues to sell around the world in English and more than 60 translations. Porter established the basis of the way a company could establish differentiation from competitors in a way that could be sold to customers.

Shapiro, E. C. (1998) *Fad surfing in the boardroom: reclaiming the courage to manage in the age of instant answers*. Capstone. (First published in 1995.)

One of Shapiro's best points is her detached and occasionally cynical review of research done on companies who have implemented a new management technique (e.g. TQM). Shapiro's main point is that while all good ideas should be considered, craven adoption by management without a true understanding of a business's needs will often lead to failure.

She does an excellent job in pointing out both the benefits and pitfalls of each of the major trends. Shapiro does a great service to management practices by pointing out that all of these initiatives are neither good nor bad in themselves, but can be used at the wrong time with disastrous results.

Smith, A. (2008) *An inquiry into the nature and causes of the wealth of nations*. (First published in 1776.)

This broad-ranging exploration of commercial and economic first principles laid the philosophical foundations for modern capitalism and the free-market economy. Smith's central thesis is that capital can best be used to create both individual and national wealth in conditions of minimal government interference. He believed that free-market competition advances both the vitality of commercial activity and the ultimate good of all a nation's citizens.

C Scenario 7.1: Corporate risk management

C1 Question

You are a non-executive director of a global engineering business mainly supplying car manufacturers that has grown mainly organically. It has decided to recruit a chief risk officer. You have responsibility for the final hiring decision. There is a shortlist of two candidates. The first has an actuarial/quantitative background and in the interview indicated that her approach would be highly analytical, scoring risks on a 10 point scale and working to eliminate as many risks as possible. The other has a broader business and engineering background and has suggested a more moderated approach.

Outline the relevant considerations in making your decision.

C2 How to approach your answer

The company must have clarity on its approach to risk. Unless it wants a change in methodology, it should select the candidate that best matches its philosophy.

It is particularly important that the real risk does not lie in the corporate culture. For example, an inability to consider the obvious but politically incorrect risks. An example might be savings made by reducing training. These might flatter results in the short term but could lead to longer term problems.

While it is logical to review risks in a structured fashion, it is unrealistic in many cases to attempt to ascribe precise probability beyond a basic high low and medium. This is because many risks are simply not quantifiable or because there is insufficient data to analyse.

The business also has to recognise that taking risk is inherent in any business. For a business with global reach with demanding customers an overly analytical approach may simply swamp the firm with detail that obscures what really matters.

Of course, it makes sense to eliminate some risks, for example not building a new facility in an earthquake zone. However, the best approach may often be well prepared crisis plans.

Self-test questions

1. Explain the difference between executive and non-executive directors.
2. Distinguish between the risks faced by businesses and insurable risks.
3. What is the difference between responsibility and accountability?

You will find the answers at the back of the book

Develop with drive



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Our core beliefs of Standards, Professionalism and Trust – together with your designatory letters and our Code of Ethics – enhance your standing in an ever-changing world.
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step of the way, supporting
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studies and your career.

8

Business strategy

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F Management accounts and other business controls	3.4
Conclusion	
G Scenario 8.1: Segmentation	
Self-test questions	

This chapter relates to **syllabus section 3**.

Learning objectives

On completion of this chapter and private research, you should be able to:

- examine the importance of internal operational, management and financial controls;
- examine the implications of outsourcing and offshoring;
- examine the importance of the business driving IT; and
- examine the role of segmentation within brokers.

Introduction



Strategy is the direction and scope of an organisation over the long term, which achieves advantage in a changing environment through its configuration of resources and competences with the aim of fulfilling stakeholder expectations.

Source: Johnson, G. Scholes, K. and Whittington, R. (2009) *Exploring corporate strategy*. Upper Saddle River: FT/Prentice Hall.

All businesses face negative headwinds. If a firm does nothing to respond to these forces, then it will inevitably shrink. It will become less attractive to clients, employees and prospective clients and employees. The process of developing and executing a strategy, like much else to do with management, is a function of the size of the business and where it is today.

In the context of insurance broking, a small firm employing seven people might be satisfied with 'keeping more and getting more' whereas a global firm will need something a little more sophisticated. This is not to say that smaller firms do not face similar challenges to their larger counterparts. They are just of a different scale and complexity.

Many brokers have significant investment by private equity backers and/or the general stock market, where there is pressure to demonstrate continual improvement in performance indicators (growth, profitability, return on capital employed, gearing, liquidity etc.). Brokers' business strategy must therefore reflect the demands of these external stakeholders. The ranking of the largest brokers in the UK as documented in *Insurance Times* magazine September 2018 was:

1. Marsh;
2. JLT Group;
3. Aon UK;
4. Arthur J. Gallagher;
5. Willis Towers Watson.

In just two years there have been significant changes between the top five. Firstly, following the publication of the ranking above, Marsh announced it was buying JLT Group with the purchase completed in April 2019. Then in March 2020, Aon announced that it was buying Willis Towers Watson.

However, following various due diligence activities and planned disposals and restructures, the deal fell through. The collapse of the deal was triggered by the US regulator's threat of legal action on competition grounds. The result of the collapse cost Aon a \$1bn termination fee, plus an additional \$400m in costs.

In this chapter we shall consider:

- some of the management tools used to help develop strategy;
- the concept of core competency and its application to outsourcing and offshoring;
- why the business should drive IT;
- specialisation and segmentation;
- management accounts and other business controls; and
- profit and loss management.

Key terms

This chapter features explanations of the following terms and concepts:

Business strategy	Core competencies	Management accounts	Offshoring
Outsourcing	P&L management	PEST analysis	Segmentation
Specialisation	SWOT analysis		



A Strategic tools

The common tools used in developing strategy include the following:

- **SWOT analysis** – ‘strengths, weaknesses, opportunities and threats’: this can be conducted within the firm or with outside help. It’s fair to say that opinion on this is divided. Some senior managers prefer to use consultants for this type of exercise, not the least for reasons of objectivity. Others feel that is a key role of the senior management team. The areas that this type of analysis might consider include the following:
 - Where does the business wish to get to in the short, medium and long term?
 - Which markets can and should the business compete in?
 - How can the business perform better than the competition?
 - What resources in terms of skills, assets, finance, relationships, technical competence, and facilities are required?
 - What are the values and expectations of those who have influence in and around the business?
- The SWOT analysis is often supported by a **PEST analysis**, an acronym for ‘political, economic, social, and technological’. Quite often it is expanded to also include ‘environmental and legal’, resulting in the acronym PESTEL. It is an analysis of the market place in which the firm works and the key factors driving change within its business environment. This is an area where it may be more effective to use outside help to conduct some of the needed research. Of course, in the age of the internet, a huge volume of material and tools are available online.
- Specifically commissioned research conducted with key clients and suppliers by specialist contractors.

The output from this work needs to be consolidated so that it can be considered by the senior management of the firm. Larger firms are likely to require a short list of options supported by further budgeting and business planning. The smaller firm can and often does take a more entrepreneurial approach. Some of the typical outcomes of the strategic review might include:

- defining the business vision of itself and the strategy to achieve that vision;
- creating a ‘mission statement’;
(NB. It should be noted that some management experts separate ‘vision and mission’ from the business strategy. This text is not the place to resolve that particular argument.)
- making a ‘transformational’ acquisition;
- entering a new business sector; and
- investing in a business that has shown recent exceptional growth.

It would be audacious to define here the right strategy for any business but there are some basic points. It should be:

- intelligible to employees, in fact everyone that will have to ‘live’ the strategy;
- capable of straightforward explanation to clients and suppliers; and
- capable of measurement with recognisable goals.

Research exercise

Review recent strategic decisions in the broking sector, such as acquisitions – particularly the Aon and Willis deal of 2020 – to identify why some work and some do not.



The final step is of course execution and often this is the most difficult step. The certainty of strategic objectives in board papers and the five-year revenue projections in spreadsheets may turn to dust in the real world.

This is a simplification of one of the key management processes. Large firms tend to spend a great deal of time in refining the analysis and planning process with a desire to identify almost guaranteed success and the management cliché of 'low-hanging' fruit or quick wins. The reality is that such decisions require some form of risk taking since success can never be guaranteed. Getting these decisions right is one of the key skills of management.



Research exercise

Apply a SWOT and a PEST/PESTEL analysis to the strategy that your own firm has adopted.



Critical reflection

Think about your own firm or a competitor and consider some of the strategic choices it may face. For example:

- if you are a mid-sized broker, making a smaller acquisition to help expansion; or
- if you are a large firm, achieving 'double digit' growth.

B Offshoring, outsourcing and core competencies

As business tools, reducing cost and improving efficiency through **offshoring** and **outsourcing** are well established.

Offshoring is where a selected function, such as payment and accounts, is performed in an overseas and presumably lower cost location, where the relevant skills are available. Don't forget, many businesses already centralise certain functions within the UK.

Outsourcing is the contracting out of a service or function that was previously performed by in-house employees. Traditionally, many businesses and public sector organisations have outsourced functions such as office cleaning, security and catering. Now, many large companies outsource so called 'non-core functions' such as call centre services, IT support, accounting and so-called 'back office' functions like payroll.

These functions are passed to specialist outsourcing contractors that may be based in the same country as the principal or are often located overseas, typically in India, the Philippines and Eastern Europe.

Outsourcing and offshoring are based upon the management concept of core competencies. The main ideas about core competencies were developed by C K Prahalad and G Hamel through a series of articles in the Harvard Business Review followed by a best-selling book, *Competing for the future*.

It seems that the trend of outsourcing is cyclical and dependent on the needs of the business. Companies that have used outsourcing in the past, where it has not been correctly aligned to the business and well managed, found that standards often diminished and the poor publicity from clients had a very detrimental effect on the business and its reputation.

Outsourcing has in the past been perceived as a 'dirty word', especially when the service standards to the consumer appear to reduce as a result. It can, however, work successfully in specialist areas where it is aligned carefully with the business and can add value. Most large firms use outsourcing companies, like Capita and Serco. Because of how well the relationship is managed, clients do not realise that they are dealing with another organisation.

Core competencies are those capabilities and most significant skills within the corporation that are distinctive to the company and are critical to a business achieving long-term competitive advantage.

A company's core competencies are the things that it can do better than its competitors in the critical, central areas of the company where the most value is added to its products and

services. These areas of expertise may be in any area from product development to employee dedication.

A competence which is central to a business's operations but which is not exceptional in some way should not be considered as a core competence, as it will not generate a differentiated advantage over rival businesses. It follows from the concept of core competencies that resources that are standardised or easily available will not enable a business to achieve a competitive advantage over rivals.

Research exercise

On the basis of your knowledge and previous study, consider all of the services and functions performed by an insurance broker and divide them between those that you consider to be a core competency and the rest.



Broking management decision: Core competency

Evaluate the concept of core competency and where it sits in your own business model, and decide whether it has any application to your business.



B1 Why do companies outsource?

The most prominent advantage is the fact that it often saves money. Many of the companies that provide **outsourcing** services are able to do the work for less money. They can do this because:

- the tasks are carried out in low-cost locations, particularly overseas where salaries and benefits are relatively low compared with the UK and there is an availability of suitable skills; and/or
- the contractor gains efficiency from specialisation and economy of scale, e.g. a catering contractor will be able to source food far more economically, or an outsourcing contractor may have a number of similar contracts with different phasing of demand that enables the work to be done with fewer people.

However, today many businesses recognise that while saving money is important, the key benefit is that outsourcing allows companies to focus on their core competencies and gain from the benefits of specialisation. Often these benefits can far exceed the pure economic savings.

B1A Potential disadvantages of outsourcing

Naturally, there are disadvantages to outsourcing as well as benefits. The longer list given here is not to suggest that this text is against outsourcing; it is to emphasise the risks so that these are anticipated and managed effectively. However, as we have already discussed, when risks are managed well, outsourcing can bring huge benefits.

Loss of managerial control: When a function is outsourced, a contract is signed with another company to perform the function within certain parameters (and as a consequence some of the management and control of that function is also outsourced). Despite the presence of the contract and, no doubt, a range of key performance indicators (KPIs) and service standards, the outsourcing company may not be driven by the same ethos and standards as your own.

Loss of personal support: When a given function (e.g. the IT helpdesk), is retained in-house, the business can rely on a personal and dedicated service, particularly when a problem needs a fast solution. Once this type of function is outsourced, the contractor will often only provide service within the strict parameters of the contract and the service standards specified.

Hidden costs: Anything not covered in the outsourcing contract will be the basis for additional charges. There will be legal fees to review the contracts and of course the management time required to negotiate the contract. This is the outsourcing company's business and they will often drive the drafting of the contract, although the benefit of experience has led to a greater tendency for the source company to control contract drafting.

Threat to intellectual property security and confidentiality: When a function is outsourced, inevitably intellectual property and confidential data have to be given to the

outsourcing contractor. Although the contract will contain strict confidentiality conditions, the fact that people outside the business will have access to this vital data increases the risk that it will be stolen. Extremely careful vetting of outsourcing contractors and their internal security is required when any contract involves sensitive information.

In fact, there is now a trend for the outsourcing of particularly sensitive functions of, for example, the manufacturing of a product with valuable patented components, being withdrawn from foreign contract manufacturing locations in view of the risk of theft of intellectual property.

Quality: The outsourcing contractor is naturally motivated by profit. Since the contract will often fix the price of a service or product, if the price is set too low, they may attempt to redress the balance by reducing quality.

This was certainly a problem in the early days of outsourcing when some of the promised cost reductions were exaggerated, particularly in cases where the outsourcing of the function meant the transfer of employees to the outsourcing contractor. Obviously this can lead to severe problems with the contract. Today this problem is recognised by a reduced focus on extreme cost savings in comparison with the wider benefits of outsourcing such as improved focus on the core business.

Exposure to the solvency of the outsourcing contractor: Outsourcing exposes the company to the failure of the outsourcing contractor. This requires attention to be paid to the contractor's financials at the beginning of a contract and throughout its duration. The risk of the contractor's failure also needs to be built into the company's enterprise risk process and business continuity planning.

Bad publicity: The word 'outsourcing' brings to mind different things to different people. Where jobs are lost as a result of outsourcing or offshoring (and they often are) this may lead to local and national resentment, reduced morale in the remaining workforce and risks attracting bad publicity. Outsourcing has also seen bad publicity from allegations of bad working conditions and the use of child labour.

Client relationships: Outsourcing can involve direct communication between the outsourcing contractor and the company's clients. This presents an increased risk of poor service from the contractor adversely affecting client relationships. This has been a particular issue with the outsourcing of call centre work to India where, despite the long tradition of the use of English, there are undoubted communication problems. As a result, most 'face and voice' outsourcing is now done in the same country with foreign outsourcing contractors limited to other so-called 'back office' functions.

B1B Requirements for successful outsourcing

Clearly the objective should be to avoid many of the disadvantages described above. In the 1990s and early 21st century, outsourcing and offshoring had become a management fad. Aligned with business process re-engineering, it played an important part in cost-reduction programmes.

A good example of a successful business making maximum use of outsourcing is Nike, the sports goods manufacturer. It has decided that its core skills are:

- product design, research and development;
- marketing and advertising;
- corporate, team and individual sponsorships;
- retailer and wholesaler relationships; and
- reputation management.

Everything else is outsourced, although the company keeps some manufacturing of patented products to a small number of companies near its home office so as to minimise issues with theft of intellectual property and copying.

For a business like Nike, this can make sense as there are now many contract manufacturing businesses that can deliver high-quality products at competitive prices.

As a consequence, Nike devotes considerable time to managing its outsourced resources to ensure maximum benefit. This is an example of a requirement for successful outsourcing. Just because a function has been transferred does not mean that responsibility has. The business must be willing to invest time in managing the outsourced function and the cost of

this must be taken into account when considering the cost/benefit case for an outsourced project.

One of the reasons that outsourced projects can fail or at least not deliver in the early days in the way expected is that, too often, a major function will be outsourced without proper consideration of the impact if things go wrong.

For example, imagine a firm that decides to send all of its invoicing to a contractor and the new system/process crashes rendering the firm unable to bill its clients. This could lead to severe cash flow problems and the expense of rectifying the problem. The driver for these 'big bang' type of approaches is of course to deliver the promised benefits as quickly as possible.

Therefore, in an ideal world, an outsourcing project should be divided into 'bite-sized chunks', with each being properly tested and piloted to remove the inevitable glitches so that the function can then be scaled up.

One reason often given for outsourcing in the past (especially with respect to IT) was: 'We don't have the skills or understanding to do it right. Let's outsource it to someone who does'.

But perhaps the approach should be: 'Let's understand what we don't understand and be absolutely clear in what we need to do to achieve competitive advantage', thereby recognising that doing something at the lowest possible cost may be an illusory objective.

One approach is to be willing to hire the necessary expertise to help make the decision. If this is the case, is it better to take on the relevant people full time or employ consultants? Most businesses are not keen to increase headcount, but this may be a relatively small cost when compared with the risk of a ten-year outsourcing contract going wrong.

C Operations driven IT

In 1620 the English statesman and philosopher Francis Bacon said that typographical printing had 'changed the whole face and state of things throughout the world'. From its invention by Gutenberg in the 15th century, the printing press using movable type revolutionised Renaissance society. The printing press spread rapidly through Europe, making over 100,000 monks redundant in the process, but leading to an explosion of literacy: perhaps not quite the same as the internet-driven change of today but as equally profound in its time.

There are many other examples of technological change from history so in some respects, the IT revolution of the past 25 years is not a new phenomenon. It is just the human condition to think that these changes are the most important in history because they are happening to us today.

The digital revolution is considered to have begun in the late 1970s, with the adoption of computers and digital record-keeping.

However, it wasn't until the early 1990s the use of the internet became common within the commercial business world. Companies in the UK often found their systems slowed down when the USA and other territories opened for business a few hours behind them. Electronic trading and the capability to upload lines and slips into London remotely from around the UK opened the floodgates for online placing of insurance products; this reduced the need for brokers to visit each underwriter and get a risk signed down.

As IT's power and presence have expanded, companies have come to view it as a resource ever more critical to their success, a fact clearly reflected in their spending habits. In 1965, according to a study by the U.S. Department of Commerce's Bureau of Economic Analysis, less than 5% of the capital expenditures of American companies went to information technology. After the introduction of the personal computer in the early 1980s, that percentage rose to 15%. By the early 1990s, it had reached more than 30%, and by the end of the decade it had hit nearly 50%.

Reprinted from 'IT Doesn't Matter' by Nicholas G. Carr. Harvard Business Review, May 2003.



According to figures from Gartner (www.gartner.com/newsroom/id/3871063), worldwide IT spending is projected to increase in 2018 to approximately \$3.7 trillion, which is a 6.2% increase from 2017.



Consider this...

The IT spend has stayed quite static since 2016 however technology and emerging risks are continuing to develop. Consider the impact this will have on insurance and review emerging risks such as Block Chain and other disrupters to the market in line with plateau of IT spend reported.

If you aspire to the senior management of any business, let alone an insurance broker, one of the toughest challenges you will face will almost certainly be a decision on IT systems updating and implementation.

There are numerous broker platforms all purporting to be the best all with their strengths and weaknesses. Larger broking houses invest millions in developing their own bespoke system as they find the 'off the shelf' offerings do not meet their needs. As a senior manager making such a decision this could be the difference between a successful business or potential failure. It might be a modest investment in an improved website, through to a company-wide sales management system. All will have promises of low-cost and fabulous productivity gains in the future.

The paradox is that as the cost of the hardware has fallen, the cost of IT implementation seems to rise, and both the private and public sector are littered with examples of expensive projects that promised much, cost a great deal and did not deliver.



Research exercise

Look at examples of successful and unsuccessful IT projects within the insurance sector, including the London Market.

Of course, many IT projects do not fail. If they did you could not read this book, use your mobile, send an email or perform many of the myriad tasks that we take for granted today. The challenge is to implement a successful IT project that delivers real value to the business and doesn't smother it.

Woolworths (the now-defunct variety retailer) streamlined its distribution with supply chain management (SCM) software from long-established partner SAP. Speaking in 2008 at SAP's Sapphire conference in Berlin, Neale Almond, business systems manager at Woolworths, said: 'The tech has contributed to a seven-figure cost saving through reduced transport and fuel costs and improved planning and productivity.'

This was a successful implementation of an enterprise resource management system that was the result of careful planning and realistic objectives. Unfortunately, Woolworths' supply chain operations were more effective than their retailing. They went bankrupt later that year.

To quote further from Nicholas G. Carr:

But the veneration of IT goes much deeper than dollars. It is evident as well in the shifting attitudes of top managers. Twenty years ago, most executives looked down on computers as proletarian tools – glorified typewriters and calculators – best relegated to low-level employees like secretaries, analysts, and technicians. It was the rare executive who would let his fingers touch a keyboard, much less incorporate information technology into his strategic thinking. Today, that has changed completely. Chief executives now routinely talk about the strategic value of information technology, about how they can use IT to gain a competitive edge, about the ‘digitization’ of their business models. Most have appointed chief information officers to their senior management teams, and many have hired strategy consulting firms to provide fresh ideas on how to leverage their IT investments for differentiation and advantage.

Behind the change in thinking lies a simple assumption: that as IT’s potency and ubiquity have increased, so too has its strategic value. It’s a reasonable assumption, even an intuitive one. But it’s mistaken. What makes a resource truly strategic – what gives it the capacity to be the basis for a sustained competitive advantage – is not ubiquity but scarcity. You only gain an edge over rivals by having or doing something that they can’t have or do. By now, the core functions of IT – data storage, data processing, and data transport – have become available and affordable to all. Their very power and presence have begun to transform them from potentially strategic resources into commodity factors of production. They are becoming costs of doing business that must be paid by all but provide distinction to none.

IT is best seen as the latest in a series of broadly adopted technologies that have reshaped industry over the past two centuries – from the steam engine and the railroad to the telegraph and the telephone to the electric generator and the internal combustion engine. For a brief period, as they were being built into the infrastructure of commerce, all these technologies opened opportunities for forward-looking companies to gain real advantages. But as their availability increased and their cost decreased – as they became ubiquitous – they became commodity inputs. From a strategic standpoint, they became invisible; they no longer mattered. That is exactly what is happening to information technology today, and the implications for corporate IT management are profound.

Reprinted from ‘IT Doesn’t Matter’ by Nicholas G. Carr. Harvard Business Review, May 2003.

As you can imagine, these trenchant views stimulated a challenging response and started a debate that is unlikely to stop. This debate is perhaps being played out in the personal lines contest between price comparison websites (aggregators) and the direct operators. While the technology appears to have enabled choice for the consumer, the product is essentially the same and the internet just another channel. It may look low cost to the consumer, but this is only because of a significant investment by aggregators and insurers.

This distribution channel has, however, changed the way in which a consumer can and will buy insurance; whether this extends in the future to more complex business purchases, or whether traditional broker methods will predominate, remains to be seen.

Critical reflection

Can IT truly revolutionise the broking sector or is it just a ‘cost of doing business’?

In the drive to find ‘total IT’ solutions that integrate every aspect of a business from customer relationships, invoicing, suppliers, management information (MI), accounting and so on, many businesses may have lost sight of the huge economic benefit of the humble email. In the insurance market it has been the great driver of productivity as tasks that previously took days and weeks can now be done in seconds.

Of course, brokers need to be run efficiently and they wish to use IT to the best effect. There are no absolute rules or guidelines to ensure that operations, by which we mean the business, drive an IT project rather than the reverse, but the following are a good place to start. In fact these ideas are true of any large project, especially one involving significant change in the business.



Table 8.1: How to ensure IT serves the business

Needs of the business	Ensure that the project is clearly aligned with the goals of the business.
	Review business processes, document them clearly and plan or implement improvements before embarking on an IT project.
	Decide upon and implement organisational design changes before implementing a new IT project, even if the two are part of the same process.
Planning	Be very clear on the scope of the project and define your requirements, but do not think that the world can be changed in one go.
	Document the requirements carefully and in detail and test these as far as possible with business practitioners.
	Be clear about the measures of success. Do not be over ambitious or plan to reduce headcount by an unfeasible amount, especially before the project is demonstrably working.
	Be ready to accept that sometimes it makes sense to keep manual processes or at least those that require human input, rather than a craven belief in automated 'end-to-end' systems. Where automated 'end-to-end' systems are proposed, allow enough time to ensure that these are ruthlessly stress tested before going 'live'.
Management	Be willing to invest in the right level of professional project management and project governance, but do not let the project management function take control. Once it has life, it will find a reason to continue living.
	Project governance must be realistic. Where many projects go wrong is that problems encountered early in the process tend to be 'parked' on the 'issues log' while the project is showing green. These issues have a habit of haunting everyone.
	Select the right balance of employees to be engaged in the project. You need a mix of skills, knowledge, enthusiasm for change and, of course, realism.
	Be willing to set a realistic timescale for the project. There is always a management imperative to rush the project, normally so that benefits – financial and productivity – can be taken early. However, a rushed implementation is likely to cost at least as much as an extra six months allowed at the beginning and often more.
	Understand the implications of 'capitalising' the cost of the project. In basic terms, this means treating the IT project as if it were a capital purchase like buying office furniture. In the short term this flatters the P&L but the price comes when the capital has to be depreciated, the cost of which runs through the P&L as an expense. This is often the motivation to rush projects, take benefits too early and ignore real problems.
Implementation	Be willing to do a real pilot test that flushes out the problems and enables the lessons learned to be an aid to the subsequent implementation.
	Over invest in training and learn lessons from early stage implementation so as to improve later training; while dedicated trainers can help the project at the start, training will need to be 'owned' by users as soon as possible. While classroom training is the conventional option, if this is given too far ahead of implementation, many staff will forget what they have been taught. Look for ways to record the training and make it accessible in real time.
Solutions	Be wary of customised solutions. These are often the source of project inflation as the promised 'flexible tool kits' and reporting software need ever-increasing sums of project money to be adapted to the needs of a specific business. This is an area where detailed scoping of the project is vital.
	Be willing to look at 'out of the box' solutions but be realistic about the compromises that might have to be made to 'bend' your business to fit the system.
	Supplier/consultant selection – an art form that could justify an entire course in itself: prepare a detailed project specification before inviting tenders; provide all the reasonable information that the bidders need to make an informed offer for your project and be willing to give them good access; be searching and absolute in requests for references, experience in your project; avoid small firms with untested software if the project is large and mission critical; take up credit references; and be clear on who will be doing what.
	Include a draft contract in the tender documentation and don't impose unreasonable conditions including onerous indemnities.
	Seek absolute clarity on what is in the price and what would be extra.
	Think hard about using small software suppliers, especially for a big project. They may simply not have the resources to cope with the needs of your business and the project itself.

D Specialisation and segmentation

The Spaniard looked at the magnificent scene in front of him and gasped in amazement. The year was 1436 and he was in Venice to see how the Italian city state armed its warships. Back home, this was a laborious process taking days, but here before his very eyes the Venetians were arming ship after ship in less than an hour a go. But how exactly did they do it?



Back in Spain, ships had to be tied up at the dock as hordes of workers loaded the vessel with fresh munitions and supplies. In Venice, by contrast the ship was towed down a canal and the different specialist weapon producers lowered their products on to its deck as it passed by. Mouth gaping, the Spanish tourist recorded the process in his diary. He had just witnessed the apotheosis of the division of labour: one of the world's first production lines.

The idea is simply this: we can produce far more, far better by dividing up the work and specialising in what each of us is good at.

Source: Conway, E. (2009) *50 economics ideas you really need to know*. London: Quercus.

Market segmentation is a natural result of the vast differences among people.

Source: Donald Norman



In his book *The rational optimist* Matt Ridley makes a strong case that the success of humans is due to a combination of **specialisation** and exchange. Over time, individuals develop skills that are valuable and they exchange these with other individuals with different skills. Fishermen fish and trade their produce for hooks or clothes made by other specialists. In this way a greater unit of output is obtained for a given input and productivity increases allowing further specialisation and so on.

Insurance broking is a demonstration of specialisation in action. Generally, insurance brokers only do insurance broking and related risk services. As a result they build knowledge and skills about risk and insurance that are valuable to their clients. Later we shall see how this process is refined further.

Consider this...

Why do the clients of insurance brokers value their broker's specialist skills? Consider other examples of specialisation from your own experience and reading.



The world is made up of billions of buyers with their own individual needs, wants and characteristics. No business can hope to cater for the needs of every buyer, whether consumer or business, from the same monolithic organisation. In other words, there is a general view that trying to service global corporations alongside small businesses in the same way does not make much sense.

Segmentation is essentially the identification of different groups of buyers within a market that share similar qualities and demonstrate similar buying behaviour. The segmentation process allows the business to match these distinct groups with its own distinct products and services. Segmentation is a natural extension of specialisation.

Table 8.2: Segmentation – criteria for success

Is the segment measurable?	Can realistic data be obtained to consider the potential of a segment? A colleague, when discussing potential future opportunities, might say: 'There are over 5,400,000 businesses in the UK and we only have 400 clients so we must be able to grow more...' It's true there are over 5,400,000 businesses, but over 99% of these are 'small' businesses employing 0–249 people and 5,100,000 are micro businesses employing fewer than nine staff (House of Commons Library Briefing paper (7 December 2015) 'Business statistics').
Is the segment viable?	Can it be profitable; what are the costs of entering the segment?
Do members of the segment have sufficient characteristics in common to make them distinct and responsive to a segmented offering?	Are these characteristics real or perceived? The middle market is often defined as businesses turning over between around £10m and £300–500m; can size alone define the behaviour of a business?
Is the segment accessible?	Where are the clients located and how does this match the existing locations of the business; how easy is it for the broker to enter the segment? Many small businesses do their 'administration' at night or weekends so your offering needs to be available when it is needed, not just in 'normal' office hours.
Is the segment already well served by competitors? Is the segment growing?	But remember that segmentation in a shrinking market can still work if it is a means of providing a service to that segment at a profit.
What investment needs to be made in expertise and resources? How will segmentation fit within the existing structure?	Can the culture of the firm cope with the different management approach required by segmentation; are new service and support structures required?
To serve the segment, does the firm need to physically organise itself around the segment or can it be done 'virtually'?	For example, if a broker decides to look after all personal lines business separately from commercial, does it need to move the business to one location or can it be distributed?

D1 Benefits and challenges of specialisation and segmentation

As with most questions in business, generally there are no right or wrong answers. All businesses both specialise and segment their customers to a greater or lesser extent. A small business that sells fishing equipment has both specialised and segmented its market. At the other end of the scale, Ford, Volkswagen and BMW all make cars. That is their specialisation, but they all have distinctly different market positions and customer segmentation. BMW could be seen as 'upmarket', but it makes cars to suit a fairly wide range of markets except the low-cost end.

The management challenge comes as firms grow in size and decisions have to be made about where scarce resources are to be allocated. Most firms find that almost inevitably they need to find ways to differentiate themselves from their competitors and the blend of specialisation and segmentation is one route to success.

Table 8.3 provides a non-exhaustive list of the advantages and disadvantages of the various forms of specialisation and segmentation.

Table 8.3: Advantages and disadvantages of the various forms of specialisation and segmentation

Advantages	Disadvantages
- Improved differentiation from competitors leading to an increased market share. - Greater recognition and brand awareness by being recognised for specific skills. - Greater productivity and efficiency. - Possible economy of scale by serving distinct groups of customers in the same way. - Attraction and retention of more skilled employees. - Creating new opportunities by discovering market segments that are inadequately served.	- Specialist staff can be more expensive and demanding. - Some clients may object to being handled alongside other similar clients for reasons of market position confidentiality. - The creation of specialist areas might lead to unhappiness among other employees not so designated. - There can be a demand from the leadership of specialist sectors for more or less autonomy from group wide resources and standards leading to inconsistent behaviours and standards. - Since not everything can be segmented, the process inevitably creates 'rumps' of undifferentiated business that might be difficult to manage. - Segmentation requires investment that may not be viable against the increased costs or against other more valuable initiatives.

Note: The majority of businesses engage in specialisation and segmentation to some extent. However, just because an idea works for one business, doesn't mean it will work for another.

Specialisation and segmentation often form part of the business strategy described above. They are also of great relevance to insurance brokers as you will find in the next chapter.

Research exercise

PC World (part of Dixons Carphone plc) is a specialist retailer selling consumer and business electronics through its stores and online. It competes with other major retailers such as John Lewis, Argos, Best Buy, ao.com and the supermarkets. Use the internet to research the history of PC World to understand how segmentation works in this highly competitive sector and how it is responding to the challenges from the competition.



D2 Production, sales and marketing-led organisations

Henry Ford, the founder of the Ford car manufacturer is famously attributed with saying in 1909 that his customers could have the Model T Ford 'in any colour they wanted as long as it was black'. This is perhaps the best example of a production-led business whose products are so innovative or desirable that the customer has little or no choice in the matter.

In reality, even Ford himself would have admitted that his statement was not really true, at least not for long. The success of Ford in building cars that people wanted to buy and, most importantly, were willing to pay for, was just one of the steps in the process of specialisation and segmentation that began with early humans and progressed through the industrial revolution to today's hectic pace of innovation.

One characterisation of business progress is that in the 20th century, businesses went from the attitude supposedly espoused by Henry Ford, through sales-led organisations to the marketing-based businesses of today. The sales-led business recognised that in a competitive and developing market place, it was necessary to bring products and services to the attention of customers and present them with features and benefits in the way that appeared to meet the customer's needs.

In practice, the business was still promoting the products it had built, but using more sophisticated means of persuasion to get the customer to buy.

Today's businesses will mostly describe themselves as marketing-led. The change in style was driven by many factors. The US auto industry found itself facing intense and successful competition from foreign manufacturers. The rise of the consumer movement led to more-demanding customers. Inflation, the IT revolution and rapid technological advancement all had a tremendous impact. The demands of investors became greater and increasingly short term. Finally, competition intensified as new business models were developed.

The simple definition of marketing is the identification of the wants and needs of customers and finding the most satisfactory way of fulfilling those wants and needs. So the business is absolutely sensitive to every aspect of its chosen marketplace and succeeds by responding accordingly.

The level of truth in this is a matter of perspective. On the face of it, the mobile phone market is hyper-competitive and customer-sensitive. Yet despite the competition, this does not seem to extend to the simplicity and fairness of mobile phone contracts. As a marketing aside, 25 years ago would anyone have said that a mobile phone would become a modern-day necessity and that in the UK there would be more phones than people?

In reality, this description of the progression from production- to marketing-led businesses is something of a simplification. Even today, most businesses will exhibit something of all three approaches. For any manufacture or service supplier to respond to every single customer nuance would be ruinously expensive. We also have the example of some low cost airlines where the only need responded to is the price of the ticket and often that is not so easy to identify. And most businesses rely on a sales function, however sophisticated, to identify and capture the best prospective customers. Brokers, as we saw earlier are no exception.



Consider this...

Consider your own firm in the context of the three types of organisation described above and decide what type of business it is. Are you able to identify areas of the business that focus on the other two approaches? Why might this be the case?

E Organisational structures

The traditional hierarchical structure of a business concentrates power at the top of the organisation, with limited decision-making delegated down through the ranks. In many respects it is similar, indeed based upon, a military command structure. Its characteristics are said to include:

- long chains of command with orders flowing down and information flowing up;
- strong centralisation of decision-making and functions;
- spans of control whereby each manager throughout the organisation would have no more than eight or ten direct reports;
- limited lateral information flow and slow decision-making;
- formal communication systems, but limited explanation to the workers;
- limited adaptability to change; and
- close association with the production- and sales-led organisations described earlier.

This model has been hugely successful, especially in the long period of growth from the 1950s to the first oil price shock of the early 1970s and continues in many organisations today. However, competitive forces that led businesses to adapt their approach to satisfy their customers subsequently led to a great deal of experimentation with new structures, processes and methods of management. These included:

Total quality management: this and related schemes attempted to emulate the apparent ability of Japanese manufacturers to make products that were more reliable.

Business process re-engineering (BPR): the theory was to redesign business processes to make them more efficient; often BPR involved the reduction in the number of hierarchical layers of management to create so called 'flatter' management structures.

Lean: A relative of BPR that also seeks to eliminate waste, increase productivity, and improve customer service and satisfaction.

Matrix and practice-based structures: the **matrix structure** became popular during the corporate re-engineering and flat structure management craze of the 1990s. A matrix structure is one where a conventional hierarchical organisational structure is in place, but individuals are given additional functional tasks such as the leadership of a practice focused on a particular client group or a particular specialisation. Generally, these tend to cut across the hierarchical structure.

The concept of the **practice structure** has been adopted by many professional service firms such as the large accountants, lawyers and management consultants. In this approach, staff may work within a conventional divisional or hierarchical structure that may contain some features of specialisation or segmentation, while at the same time working within a 'practice' that may be organised around a specific client segment such as pharmaceuticals, manufacturing or retail. Some firms group all clients into practices, others segment them by size within the practice.

Centralisation of functions: this involved 'back office' processes such as accounting, legal, compliance, in some cases quality management being brought together, relocated offshore or handled by 'shared services' functions that could be outsourced.

Decentralisation: while many businesses tended to centralise some functions as described above, businesses were given more local authority so that decisions could be brought closer to the end customer.

Change management: Recognising that change is inevitable, this was a process of driving change through the implementation of various forms of new management as summarised here, often at a pace that was unrealistic or ill-suited to the underlying business.

Global, strategic business and product/service units: essentially the grouping of related businesses together under one management, sometimes organised on a global basis; this was the opposite of the more traditional country-based management that had been deployed by many global businesses.

Employee empowerment: the practice of delegating more authority to employees at the 'front line', dealing with customers so that they could make decisions that would improve customer service.

This is just a sample of some of the more prominent ideas that were promoted by a growing band of management consultants and adopted by senior managers as a solution to business challenges. In many cases the changes were profound, disruptive, often expensive in terms of jobs, and that many traditional companies failed to implement successfully. Some firms have been through several cycles of change, including decentralisation and back again.

The reality is that all businesses retain a hierarchical structure. In some it is overt and at least everyone should know where they stand. In others it is covert, often disguised by supposed non-hierarchical structures and inclusiveness.

Critical reflection

Cycles of change in the car industry

It is difficult to say what leads to success today. General Motors, once one of the largest car makers and largest businesses in the world, the apotheosis of the 1950s business model described earlier, is now a shadow of its former self. Its nemesis, Toyota, was (until 2016) the world's largest car maker with a reputation for high-quality cars, the most efficient manufacturing processes and clear execution of strategy. Yet during 2010 it was beset with unprecedented quality and recall problems.

In September 2015, the German car maker Volkswagen (VW) hit the headlines following the diesel emissions scandal. However, despite the negative publicity the scandal has had very little effect on VW's business and rival manufacturers, like Toyota, have fallen behind in global sales as of 2016. This has been attributed to VW's restructure in the wake of the scandal.

bloom.bg/2AdiA21.bit.ly/2TrwN1Q.

How did the VW organizational structure affect the outcome of the scandal?



Research exercise

Use the internet to research business terms such as 'business process re-engineering', 'delaying', 'decentralisation' and 'employee empowerment' so that you can identify how different management ideas have waxed and waned.



F Management accounts and other business controls

In the UK, statutory financial reporting requirements are annual, with a summary required at the half year. This is distinct from US practice where quarterly statutory reporting applies. No business can wait twelve months to find out if it has made a profit or a loss. Most businesses therefore use a mixture of so-called **management accounts** and other financial and general metrics to control the business. Some by their nature are backward-looking; they tell the business what it has done. Others seek to be forward-looking: what will the business achieve?



Research exercise

Find out as much as you can about the operational and financial controls used in the business you work for and identify how they are applied and the action that results from them.



Management accounts

A set of summarised accounting data (balance sheet, cash flow, and income statement) prepared and presented (usually every month, fortnight, or week) specifically for a firm's management. The objective of management accounts is to provide timely and key financial and statistical information required by managers to make day-to-day and short-term decisions. Real-time management information is also used to track immediate productivity and indicate trends that can be monitored throughout the business.

The range of management information that a firm may choose to monitor is defined by its size and management style. Table 8.4 provides a good, non-exhaustive sample.

Table 8.4: Types of management information

Financial	Monthly, annual and multi-year budgets that capture revenue and costs incurred by the business, e.g. salaries, printing, travel etc.
	Forecasts of expected revenue, expenses and profit for the remainder of the firm's financial year, adjusted for known information and latest views of trends.
	Weekly or monthly revenue analysis by individual client and in total: may be divided between renewals, new business from existing clients, 'new new', and cross-selling.
	New and lost business by case and revenue.
	Debtors by age, cash collection performance and cash balances by branch or division internal audit, including reconciliation of cash daily/weekly/monthly.
Business targets	Won to lost ratio. The former must be greater than the latter or the business is shrinking.
	New business pipeline. Often, prospects within the pipeline are valued and weighted according to the chances of winning the business in order to give a total value of the pipeline. See more in Components of the sales process on page 4/2.
	Retention ratio. Most businesses need to exceed 90% to grow; the best businesses will target a ratio of 95%+.
	Hit rate of new business – the number of cases won against the number reported on.
	Internal audit and compliance reports against previously set standards, e.g. quality systems.
	Contract certainty at inception (CCI) performance.
	Complaints – an FCA requirement.

Table 8.4: Types of management information

Stakeholders	Staff turnover and absence; actual full-time equivalent staff against plan.
	Staff opinion surveys.
	Surveys of client views.
	Premium volumes by insurer, preferably using rolling twelve-month numbers to smooth short-term fluctuations.
	Clients at risk – often in a RAG (red, amber, green) status report. The threat to the account will be affected by events such as a change to the senior decision maker, problems with a claim, unsatisfactory renewal terms etc.

An example of a monthly reporting template is given in appendix 8.1. You can find this on RevisionMate.

Broking management decision: Reporting metrics

Consider the range of regular reporting metrics and the actions that you would take if any given metric was ahead of or behind schedule.



F1 Using management information

Clearly there is little point in collecting this data if it is not used to drive the business. The frequency with which data is reviewed and the action taken is decided by the scale of the firm and the way it chooses to run itself. Large brokers, especially if they are listed, will look in detail at their numbers at least monthly and some more often. Businesses with US listings need to comply with the typical US quarterly reporting cycle, where key financial data has to be published every three months.

Depending upon the size of the firm the pattern might be something akin to:

Weekly	Conference calls to deal with short-term issues and allocate resources to solve problems and support initiatives.
Monthly	Senior executive meetings to consider data in more depth, review progress against plans and take more action to deal with problems and allot responsibility and accountability for required action.
Twice-yearly	Meetings to take a longer view and react accordingly.
Annually	Planning and strategy reviews.

Depending upon the size of the broker, this pattern of meetings may also take place at a branch or divisional level as well as that of the senior executives. The action that might be taken and who is responsible for it as a result of this information will naturally vary depending upon its nature. Here are a few examples:

- **Complaints rise at a branch:** while the responsibility must lie with the branch director, the investigation may be assisted by another branch director or another senior person that is not directly connected with the branch.
- **Overall retention falls below the planned target:** this might call for meetings with ex-clients, analysis of performance by branch or individuals' workloads, or investigation into competitor entry/threat; these tasks might be led by a senior person not directly responsible for branch operations, such as the finance director or sales director.
- **Failure or near failure of a compliance or internal audit:** this will require immediate action to rectify the problem, and may also require a longer-term plan of training and education.
- **New business is far ahead of plan at one particular location:** this is good news and one objective would be to discover what is being done right so that it can be replicated elsewhere; this looks like the responsibility of the sales director. It should be noted here that excessively high volumes of growth could also indicate underlying issues to the business.

F2 P&L management

As part of their management accounts, many larger firms and brokers are no exception, operate segment-based non-statutory P&Ls for specific divisions. These might be compiled nationally, or in some cases globally, where this approach is seen to better reflect the nature of client or business needs.

An obvious question is why go to this trouble since it adds an extra dimension of complexity when the management of a big business is already difficult enough?

The reasoning for separate P&Ls is that they can be used to drive a segment-wide approach to high-quality service and provide a focus for the whole team within the segment. They will be used to decide segment bonuses. While the majority of segment based P&Ls are produced nationally some firms operate global P&Ls where the business is managed on a global basis.

Examples of global P&L management found in brokers include those serving the global energy, accountants and aviation markets.

There are some obvious challenges in this approach. Not least is the need to get the allocation of central overheads right, and to reflect somewhat different approaches to remuneration in different locations around the world.

As a result, most of the larger broking firms operate P&Ls for each country, but with multi-country practices in order to achieve cohesion across a segment or specialisation.

Conclusion

Successful modern businesses have adopted many aspects of the ideas described above. There is no standard recipe for success as is illustrated in the following table. It shows the world's largest companies by market capitalisation in 1912, 1998, 2012 and 2018.

It serves no other purpose than to say that nothing is forever. Some of the companies in the 1912 list have shrunk or disappeared as a result of poor strategy. Others demonstrate the changing nature of the role of different sectors in individual economies and the rise of China. It is interesting to identify the movement of companies due to the changing world of technology and the movement of requirements of natural resources.



On the Web

The complete article by Professor John Kay may be found at:

bit.ly/2jpqv1A.

It provides the history for 1912 and 1998. The 2012 and 2018 information has been added for perspective.

Rank	1912* Capitalisation \$m	1998* Capitalisation \$bn	2012† Capitalisation \$bn	2018** Capitalisation \$bn
1.	USX (steel, US) 741	General Electric (electricals, US) 223	Apple (technology, US) 559	Apple (technology, US) 927
2.	Exxon (oil and gas, US) 390	Royal Dutch Shell (oil, UK/N) 191	Exxon Mobil (energy, US) 409	Amazon (online retail, US) 778
3.	J & P Coats (textiles, UK) 287	Exxon (oil, US) 158	PetroChina (energy, China) 279	Alphabet (technology, US) 766
4.	Pullman (railcars, US) 200	Coca-Cola (brands, US) 151	Microsoft (software, US) 271	Microsoft (software, US) 751
5.	Royal Dutch Shell (oil, UK/Netherlands) 187	Intel Computer (chips, US) 151	IBM (software and computer services, US) 242	Facebook (social media, US) 542
6.	Anaconda (copper, US) 178	Merck (pharmaceuticals, US) 121	Industrial & Commercial Bank of China (bank, China) 236	Alibaba (consumer services, China) 499
7.	General Electric (electricals, US) 174	Toyota Motor (cars, Japan) 117	Royal Dutch Shell (energy, UK) 222	Berkshire Hathaway (non-life insurance, US) 492

Rank	1912* Capitalisation \$m	1998* Capitalisation \$bn	2012† Capitalisation \$bn	2018** Capitalisation \$bn
8.	Singer (machinery, US) 173	Novartis (pharmaceuticals, Switzerland) 104	China Mobile (telecommunications, Hong Kong) 221	Tencent Holdings (technology, China) 491
9.	American Brands (cigarettes, UK) 159	IBM (computers, US) 104	General Electric (general industrials, US) 212	JPMorgan Chase (financial, US) 388
10.	Navistar (machinery, US) 160	Philip Morris (cigarettes, US) 101	Chevron (energy, US) 211	ExxonMobil (oil and gas, US) 344
11.	BAT Industries (cigarettes, UK) 159	Procter & Gamble (brands, US) 93	Wal-Mart (general retailers, US) 208	Johnson & Johnson (pharmaceuticals, US) 341
12.	De Beers (diamonds, RSA) 158	British Petroleum (energy, UK) 86	Nestle (food producers, Switzerland) 207	Samsung Electronics (electronics, South Korea) 326

* Source: Kay, J. and Hannah, L. (1999) 'Marshall's 'trees' and the global 'forest': were 'giant redwoods' different?' in Lamoureaux, N., Raff, D. and Temins, P. eds., *Learning by doing in markets, firms and countries*. National Bureau of Economic Research and University of Chicago Press.

† Source: Financial Times, Global 500.

** Source: Statista, www.statista.com/statistics/263264/top-companies-in-the-world-by-market-value/.

Additional reading

Hamel, G. and Prahalad, C.K. (1996) *Competing for the future*. Harvard Business School Press.



G Scenario 8.1: Segmentation

G1 Question

Your firm has two businesses: in theory, one caters for SME business and the other for middle market and large national accounts. In practice there are many accounts in both businesses that, based on the criteria drawn up for a segmentation process, should be relocated.

Explain how you would go about identifying the correct segmentation criteria and deciding where individual accounts should be located.

G2 How to approach your answer

Key points of content

You should aim to include the following key points of content:

- Build a database of every case showing its size, trade, current income and current service team and location.
- Devise (in consultation with the current business leaders) the right segmentation structure by size and, where viable, individual trade segment.
- Consider whether the rigid implementation would create areas that were not viable, for example, a branch with a large middle market book with only a few SME cases.
- Consider whether class-based segments are needed to deal with specific classes of insurance or trade groups, e.g. contractors.
- Build new P&Ls based upon the division of accounts into the new structure.
- Consider how the current geography of the business would match the new segmentation.

Self-test questions

1. What is a SWOT analysis and how is it used?
2. Define segmentation.
3. What are the reasons that might lead to a company choosing to outsource?
4. Explain the meaning of management accounts.

You will find the answers at the back of the book

9

Key aspects of insurance broking operation and management

Contents	Syllabus learning outcomes
Introduction	
A Broker organisation	3.2
B Global business	3.3
C 'Wholesaling'	3.1
D Terms of Business Agreements (TOBAs) with insurers	3.7
E Managing general agencies (MGAs) and delegated authorities (DAs)	3.8
F The impact of public opinion	3.9
G Scenario 9.1: Centralising services	
Self-test questions	

This chapter relates to **syllabus section 3**.

Learning objectives

On completion of this chapter and your own private research, you should be able to:

- describe the various types of intermediary – by size, specialism and geographical scope;
- analyse typical management structures;
- examine the challenges of international and global business;
- explain the role of Terms of Business Agreements with insurers;
- explain the management of delegated underwriting authorities; and
- examine the impact of public opinion on the wider insurance industry and the role of the Chartered Broker status in raising professional standards.

Introduction

Insurance broking firms form a diverse group. The UK has around 3,000 brokers according to the British Insurance Brokers' Association (BIBA), with an estimated 85% being defined as 'small brokers' – employing ten or fewer employees.

The number of brokers in the UK has halved in the ten-year period from 2005 to 2015, this trend continued over the next five years, mainly due to consolidators purchasing smaller brokers including owner-managed firms. So they vary considerably in the size and scope of their operations. They comprise:

- large global firms that engage in a wide range of activities and employ thousands of staff around the world;
- UK-only based firms that range in size from single principal firms with two or three employees, through larger regional businesses to national firms;
- consolidators that have built large businesses from the acquisition of many small firms;
- firms that concentrate on niche sectors, such as media risks, care homes, alarm companies, equine risks and so on;
- brokers that act as 'wholesalers' for other brokers;
- pure reinsurance brokers;
- brokers that compete with direct marketers by exploiting call centres, the internet and full-cycle electronic processing; and
- brokers operating a totally online presence, both direct to private and commercial customers and other brokers.



Key terms

This chapter features explanations of the following terms and concepts:

Aldermanbury Declaration	Broker organisation	Centralisation	Delegated authorities
Risk transfer	Wholesaling		

A Broker organisation

The FCA, through its High Level Standards, the Principles for Businesses, Senior Management Arrangements, Systems and Controls (SYSC) and Threshold Condition 4 expects brokers to be organised and managed properly so that firms may comply with their obligations under the regulations and to their clients.



Variations on a theme

No two firms are organised in exactly the same way. In fact, considering that they are all doing essentially the same thing, the perceived cultural and organisational differences between firms can be vast.

Management structure is naturally a function of size. Smaller firms (those with fewer than say ten principals/partners/directors and employees) do not require a formal management structure. The principal(s) devote the majority of their energies to the production of business, client relationships and retention, delegating other tasks to more junior employees. Some smaller firms outsource regulatory compliance and other functions such as billing.

As firms grow larger they have to introduce structural specialisation so that the business can be managed effectively. They will have the typical dedicated functions of larger firms, such as finance and administration, credit control, human resources, legal, public relations, marketing and IT. The larger firms have also experimented with the various management ideas and structures that we considered in chapter 8.

An example of a structure of a large firm is illustrated in appendix 9.1. It represents an amalgam of different firms and does not describe an actual firm. You can find this appendix on RevisionMate.

Many brokers dealing with commercial combined business, no matter what their size, divide roles between people responsible for the relationship with the client, often known as account directors, account executives, client executives or client managers (or in smaller firms, the owners of the business), and those who look after the day-to-day insurance and technical issues like account handlers, client service advisers or client service executives. As demonstrated, there is a variety of titles for both roles.

The theory is that employees who directly engage with the client spend time with clients and prospects and look after the all-important relationships. The technicians look after negotiations with insurers and ensure that policies, endorsements and invoices are issued correctly and on time.

In a small firm these distinctions might be blurred, whereas for larger firms the separation becomes more defined. Some brokers separate new business and defensive work which is dealt with by dedicated broking staff from 'ordinary' renewals, which are looked after by technicians.

Many firms, but especially the larger ones have segmented their business and used specialisation in a number of ways:

- A structure based upon specific classes of insurance, such as directors' and officers' (D&O) liability, professional liability, construction, aviation and marine. In turn, an energy division might be divided between offshore, onshore, renewable and so on, and the business might also be segmented by the geographic source of the business. Then within these businesses, there might be a division of roles between client service, broking and 'back office' functions.
- Divisions that specialise in specific client trade segments such as retail, construction sector, property owners and investors, utilities and so on. These divisions retain and acquire clients by building expertise in the relevant trade segments.
- Practices organised globally on either a 'virtual' basis where people work together co-operatively or with a separate profit and loss account (P&L) distinct from country P&Ls.
- For larger accounts, specialists in the management of the overall relationship between the client and the various different services it may need from the broker.
- Segmentation by client size normally between SME, middle-market and large/global.
- Personal lines divisions that are further segmented between, for example, high net worth or groups such as professional footballers or entertainers.

The structures based upon class of insurance are a natural reflection of the way insurers organise themselves, which in turn is based upon the advantages of specialisation. The exception is found in commercial combined business for SMEs where both brokers and insurers tend to use generalists.

Some firms have considered arranging themselves entirely around clients and in the process doing away with the class of insurance based structure described above.

Theoretically, this has the potential advantages of:

- reduced costs as, especially on larger accounts, fewer people are needed and the 'infrastructure' required by each specialist division is **centralised**;
- more consistency of the communication of the client's risk details to insurers as the information is passed through fewer hands;
- the client knowing that the service team is also conducting all the negotiations rather than passing them off to another division; and
- consistency of service: service delivery is controlled by one team rather than relying upon the various divisions of the broker performing to the same service standard.

In practice, no broker has implemented such an approach; at least not in its totality. First there are the consequences of the loss of specialisation. There is also the inherent conservative nature of underwriters and the adverse reaction from existing staff. These are not necessarily reasons for inaction, but they are the political reality.

As a result, most brokers use a blend of the structures described above, adapted to their circumstances. All to a greater or lesser extent seek the benefits of segmentation and specialisation while trying to avoid or minimise the disadvantages.



Broking management decision: Reorganising for segmentation

You are considering the segmentation of your business into corporate and commercial, the former dealing with larger accounts, and the latter those below £15m turnover. This will necessitate some reorganisation of offices. In some locations, corporate will be the larger business and in others it will be commercial. On the basis that each office can only have one leader and that both corporate and commercial will have their respective structures, how would you ensure the success of each?



Consider this...

Think of your own experience outside of work to look at specialisation. For example, you might be willing to decorate a room but feel the need for a plumber to install a central heating system. Why do you do that, and what benefits does it give you and the plumber?



Critical reflection

Clients of all sizes look to brokers for expertise. Could deep expertise in diverse classes of insurance be developed in one individual? Are teams or information systems the answer?

B Global business

Most of the world's large companies – those operations in more than one territory – tend to buy global insurance programmes for property/business interruption, public and products liability, D&O, marine cargo, crime and so on. Some of the larger programmes can involve policies in over 100 territories.

These programmes require insurers to have networks of offices or local insurer partners with agreement to issue local policies, collect premiums and pay claims. Equally, brokers need their own network of local offices or local third party broker partner agreements to collect information, provide local service to the client, arrange for the issue of local policies, collect local premiums and monitor the performance of insurers. Both need to have effective central resources to manage the programmes and ensure that premiums are remitted to the centre, often to a client captive, within an agreed timescale.

They also need to monitor local policy issue performance and claims payments. These resources need to be staffed with people with experience of local legislation.

The global brokers compete on the basis of an extensive network of owned offices supplemented with partners in some territories. Other brokers work through a mixed network of owned offices and local partners, and there are co-operative networks of brokers that have limited operations outside their home country.

In many cases, it is unlikely to be economic for a broker to establish a local office merely to service global programmes. They need viable local business to survive. For that reason, many networks have been built through the acquisition of established local firms.

One of the current challenges of global programmes is compliance with the rules and regulations in each territory where policies are issued. Many countries forbid insurance to be arranged outside of the country, by what is typically referred to as 'non-admitted' cover. Breach of these regulations can result in the invalidation of the insurers' and brokers' local licences and possible prosecution of all parties including the client's local employees and directors.

The decision for the UK to leave the EU has left insurers, brokers and many other businesses in some uncertainty following the culmination of the transition period on 31 December 2020. This uncertainty will remain until a deal with the EU has been solidified and the future relationship has been fully established.

The initial consequence of the vote was an immediate drop in share prices and loss of value to the pound sterling. Many of the larger brokers enjoy trading cross-border via passport, and the UK exit from Europe saw the end of '**freedom of services**' insurance arrangements. Most of all, any change will affect UK trade with European partners, with many firms still reluctant to agree to any long-term deals.

Since the outcome of the referendum insurance companies and brokers have aligned themselves to operations within the EU to protect their trading ability. Lloyd's of London moved 100 of its 600 jobs to new offices in Brussels in order to retain a presence in the EU post Brexit. Its business with continental Europe amounts to £3bn a year and 11% of its overall premiums.

On the Web

bit.ly/2oz0Zlm.



Research exercise

Investigate the differences between the insurance sectors, both commercial and personal, in a selection of Western and other economies, review the impending exit of the UK from Europe and identify why this might affect insurance brokers.



B1 Challenges for brokers

Global programmes require specialist expertise not only to ensure compliance, but also to ensure that cover meets the client's needs and all aspects of the programme are serviced efficiently. This expertise is in relatively short supply, which drives up salaries.

Brokers differ in their approach to the way they organise the management of global programmes. Some brokers allow individual service teams to administer the programme, whereas others choose to centralise this function.

Advantages of centralisation	Disadvantages of centralisation
- Specialisation means the work is done more efficiently. - Greater level of expertise in the team. - Stronger relationships built due to regular contact with the broker's overseas network and understanding of their capabilities. - A more compelling proposition for new clients.	- Service may be impaired by lack of ownership. - Risk that costs will increase. - Reduced opportunity for client servicing teams to gain global servicing expertise.

B2 Dealing with data

Global programmes generate large volumes of data. What is normally done in just the UK is reproduced for every country to which the programme applies. This work can be done 'manually' by using typical office software. However, many of the larger brokers and global insurers have built dedicated IT systems to:

- gather and collate underwriting information;
- manage and monitor claims;
- hold details of local policies;
- allocate premiums and calculate insurance policy taxes;
- arrange the rapid transfer of local premiums to where it is required; and
- monitor the performance of local insurers.

These systems naturally incur a cost and can act as a partial barrier to entry for both insurers and brokers.

C 'Wholesaling'

As we have seen in earlier chapters, the London Market is a key source of capacity and expertise for brokers that specialise in dealing with other producing brokers. This is known by tradition as the 'wholesale' market, and the London Market brokers who deal with non-London brokers are known as 'wholesalers'. Brokers that provide schemes that specialise in their given area of expertise not necessarily located in the London Market will also wholesale.

The number of 'pure' wholesale brokers is shrinking through the forces of consolidation that we have seen earlier. The large global brokers also place business into the London Market on behalf of their own networks of international offices. They face similar challenges to those

described below with the addition of the occasional internal argument over the sharing of income.

The London Market cycle	- Affects the flow of business; when the local market is soft, less business flows to London; conversely when local markets are hard, London's expertise and capacity responds. - As a result, the London broker faces fluctuating revenue against a cost base that has a large fixed element with a consequent impact on profitability. When wider capacity is available, non-specialist brokers may gain access to pricing or cover that may have until then only been available to specialist brokers.
Currency	- Most foreign business is transacted in dollars, whereas for brokers based in London costs are normally in sterling thus creating a currency risk. - Some brokers mitigate this problem by processing some of this business, including policy issue, in lower-cost locations such as India.
The dominance of the 'big three' global brokers⁽¹⁾	According to the Lloyd's these brokers account for over 50% of all Lloyd's business; this has the effect of driving further consolidation in this market.
Lloyd's and the large Lloyd's syndicates	Opening foreign offices and creating further competition.
The role of London	London has no divine right to business and faces competition from local markets and new centres such as Singapore which has become a 'mini-London' for Asian business.

1. The 'big three' global brokers traditionally referred to Marsh, Aon and Willis, although Arthur J. Gallagher overtook Willis in 2015 (*Business Insurance*, July 2016) and the two tend to fluctuate, however as at 2018 tradition seems to be maintained with Marsh, Aon and Willis still being the big three.



Broking management decision: Managing relationships

In the light of the ebb and flow of business, how would you manage a wholesale broker in order to minimise the impact on profitability and service?

C1 Managing relationships with producing brokers

In practice, wholesalers are in the same position as their producing brokers, but with the added complexity that the wholesaler (usually) has no direct relationship with the original client. There are exceptions, such as for the larger risks where there is a tradition for the London broker and the lead insurer(s) to maintain a direct relationship with the client.

We do sometimes see this replicated with local brokers and their insurers. Brokers and insurers are also diversifying into added value products to ring fence and secure relationships with clients.

Thus producing brokers have to be treated in the same way as clients. This means:

- regular contact by phone, email and wherever possible face to face – many leading individuals in the wholesale broking market will spend a great deal of their business lives travelling overseas to meet producing brokers and direct clients;
- as with direct clients, relationships are strengthened through consistency of personnel and opportunities for socialising;
- rapid response to enquiries knowing that many will be 'fishing' expeditions, that is where the producing broker is benchmarking a premium or wishes to place the holding market under pressure;
- producing good quality, accurate and timely documentation; and
- regular technical briefings on market developments and cover changes.

D Terms of Business Agreements (TOBAs) with insurers

The purpose of a TOBA is to define the legal relationship between a broker and an insurer, including the scope of the broker's authority, responsibility for premium, cancellation of the agency and so on.

Written TOBAs are not officially required. The only regulatory requirement is for credit risk transfer agreements to be in writing. However, the FCA regards TOBAs as 'best practice' for both insurers and intermediaries. In their absence, a broker would have to demonstrate some alternative that was as good as 'best practice'. In reality, insurers will not do business without a written agreement and therefore, for practical purposes, TOBAs are mandatory.

Until recently, TOBAs would have included a section on business development with specific growth targets for particular lines of business, loss ratios and the payment of overrides, profit share agreements and so on. These are now generally dealt with in a separate agreement or side letter if the broker accepts such payments.

Research exercise

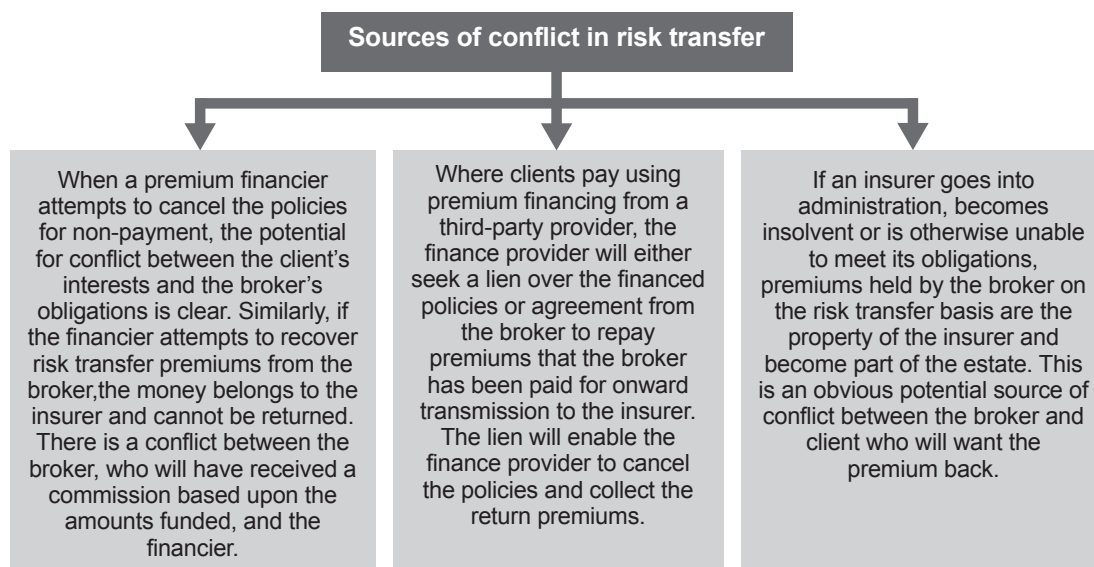
Obtain copies of typical TOBAs issued by insurers. Compare them and find the similarities and differences. Why do you think the differences exist and how might these affect the broker's relationship with the insurer?



D1 Risk transfer

TOBAs with insurers come in two basic forms. The first is known as a '*risk transfer*' agreement, where the insurer treats the broker as an agent for the receipt of premium and so is responsible for the default of the broker.

The alternative is where, in collecting and holding client money, the broker is the agent of the client, thus exposing the client to the risk of the broker's insolvency. The risk transfer basis has a clear benefit to the client. However, there are some circumstances where it can cause problems.



Broking management decision: Problems of risk transfer

As a result of the recent failure of a client who was using a premium finance arrangement, you have become aware of some of the challenges presented by these agreements and the conflict with the risk transfer basis. Explain how you would review these problems, and how you would ensure they were understood by both staff and clients.



The holding of client money is subject to Client Assets Sourcebook (CASS) requirements of the FCA that were described in chapter 5. The FCA requires brokers to seek its permission to hold money as the agent of the client, as opposed to the risk transfer basis described

above. This permission is rarely granted except for the very largest and well-capitalised firms.

D2 When is brokerage earned?

In *Velos Group Ltd v. Harbour Insurance Services Ltd (1997)* it was held that brokerage or commission is earned in full on the conclusion of the policy. As a result, if the policy is cancelled at any time or there is a part-return of premium, the original brokerage is retained by the broker in full and the client only receives the balance of the premium after the brokerage has been deducted.

Unfortunately, the custom and practice of the UK market is that when a return premium is processed, the insurer gives a credit less the applicable brokerage. In paying the return in full to the client, the broker loses the brokerage. Therefore, many brokers attempt to insert a clause in their TOBAs with both clients and insurers that require returns to be treated in the way set out in *Velos*. Insurers universally tend to refuse and most (if not all) clients would be equally unhappy at this approach.



Research exercise

Find the judgment in *Velos Group Ltd v. Harbour Services Ltd (1997)* so that you can understand all the issues in more depth.



Critical reflection

Does a clause in a broker's TOBA stating that all brokerage is earned at inception conflict with the concept of Treating Customers Fairly?

D2A Responsibility for the collection of premiums

The TOBA sets out notification procedures if the broker has problems collecting a premium. Provided the broker complies with these procedures, they are not liable for the premium in the event that the client is unable or unwilling to pay. Insurers expect these procedures to be taken very seriously by the broker and will make compliance a condition of the continuation of the agreement. Most insurers will perform some form of audit although they will pay more attention to brokers that are bad payers. An extreme step is to make the provision of cover subject to immediate payment.

The exception is the **Marine Insurance Act 1906**, which makes brokers liable for certain marine premiums.



Broking management decision: Notification

How would you manage compliance with the obligations to notify insurers if there is a problem collecting the premium? What would be the consequences of failing to abide by these procedures?

E Managing general agencies (MGAs) and delegated authorities (DAs)

In May 2017 the Managing General Agents Association published that it has 132 members and that the industry overall boasts 300 organisations underwriting over 10% of the UK's general insurance market.

Managing general agency was originally a US term that has been adopted by the UK. It can also be known as binding or **delegated authority** – **DAs** in the UK. These terms will be used interchangeably throughout this text. It is an arrangement whereby an insurer delegates underwriting and claims functions with varying degrees of authority to a third party.

The third party might be a business that specialises in running MGAs/binders or a broker, or indeed another insurer. They have been around for a long time, although they received more prominence when a number of retail brokers decided to form their own MGAs/DAs to write parts of their own portfolios. Lloyd's derives as much as 40% of its revenue from DAs operated by specialist firms around the world.

There are variations in the degree of delegation. 'Limited' delegation may only enable the submission of information, underwriting within narrow predefined limits and the binding of cover. Full authorities allow the delegatee to stand in the place of the insurer, with wide underwriting and claims-settling authority. MGAs are usually based on fully delegated authority.

E1 Why insurers and reinsurers support MGAs and DAs

MGAs and DAs are formed as an alternative to traditional insurance distribution methods.

Insurers wish to enter a market, but...	either do not wish to build their own distribution infrastructure, do not have the experience or do not wish to incur the costs of doing so. Many Lloyd's syndicates have set up such facilities to write smaller commercial and personal lines business, both in the UK and specifically in the USA; this is business that may not otherwise come to Lloyd's or where the expense of processing through the Lloyd's system is too high.
Reinsurers use them to access direct markets...	without appearing to compete directly with their clients, namely other direct insurance companies.
To offer a different proposition to small brokers	Some MGAs have been set up specifically to work with small brokers in a way that the large insurers struggle with.
The volume of business from a particular product...	is uneconomic for an insurer, but can be made less so if an MGA is used.
There are groups of individuals who have the marketing, underwriting and entrepreneurial skills who do not wish to work for an insurer	They may also have developed a new insurance product and are unwilling to take the risk and invest the time in developing the product.
As a marketing device...	for an insurer to secure an income stream from a broker in return for an exclusive product and additional remuneration.

The experience of MGAs/DAs is variable, but some have been successfully established for many years. The secret of success is a combination of providing the right long-term incentives for the manager, good risk selection and a long-term philosophy. They are of course a potential source of conflict between say, a large insurer that deals with a wide range of brokers that also supports an MGA or specialist delegated scheme broker, which distributes to selected brokers at different terms.

The motivation behind the formation of the more recent broker MGAs is slightly different. These have been aimed at the SME business sector where larger brokers face competition from much smaller firms and so find it more difficult to achieve the margin they require.

It is also at this size of client that the costs to serve become more significant. Put simply, the broker has a base level of costs that are the same for each transaction and so the smaller the transaction size, the larger the proportion of the broker's income consumed. It is interesting to note that although brokers still dominate the SME sector, in the 'micro' sector the penetration by direct insurers is increasing.

Small businesses, those employing 0–249 people, make up over 99% of businesses in the UK and micro businesses (employing fewer than nine people) make up 96% of businesses. For the broker with a sufficient volume of SME business, the attraction of an MGA is that they can eliminate the duplicated costs between the broker and the insurer.

It might also be an attractive model for an insurer that does not compete in the current SME market, has neither the need to incur the cost of distribution to many smaller brokers nor the risk of cannibalising other business.

It might also be noted that for the insurer with an established position in SME, the cost argument works in reverse in support of the direct model.

E2 Challenges for brokers

For the broker setting up an MGA or DA, the challenges and considerations are:

Regulation: In the light of the importance of MGA/DA income to Lloyd's, Tom Bolt (former Director of Performance Management) implemented more searching standards for the management and audit of these facilities.

Lloyd's reserves the right to approve senior management, including of course the senior underwriter and claims manager, and will take a close interest in all aspects of the management of the facility. This challenge applies equally to MGAs/DAs run by brokers and independent firms. However, note that at present, MGAs/DAs are not specifically regulated by the FCA, although regulated entities operating them will still have to comply with the general aspects of the regulation, such as the Principles for Businesses.

Efficiency: The broker must be confident that it can manage the whole process more efficiently than an insurer. If it cannot, the original client will inevitably bear additional costs. It also has to consider whether the additional costs will be more or less than the additional income derived.

Service standards: Brokers often complain about the service offered by insurers. In running an MGA, the broker assumes responsibility for that service and the MGA must now stand being measured against other insurers.

Data: What is the quality of the data about the portfolio? This is essential for the successful marketing of the portfolio to underwriters and understanding the profitability of the account.

Scope of business: Will it be possible for the MGA/DA to underwrite all of the business currently in the broker's target portfolio? Note that the MGA/DA will be competing for all of the broker's risks against many insurers with varying appetites.

Staff: How will staff react to the new proposition?

Resources: Does the broker have the resources to provide all of the relevant services, including documentation and claims handling?

Conflicts: The obvious conflict is that the broker may earn more money by directing business to a binder or MGA without offering the client a better price or service. However, another conflict comes with the desire for the binder/MGA to make a profit while writing as much of the broker's chosen book as it can. This means that the binder/MGA has to be competitive on far more risks than competing insurers who only have to compete on the individual risks they have chosen.

The broker has to decide whether to support the binder/MGA at the risk of poor results, or take a long-term view by allowing the facility to build over a much longer period.

In May 2014, the FCA published a report following its thematic review on conflicts of interest. A key finding was that many of the conflicts identified related to the structure of intermediaries' business and their sources of revenue. In particular, firms or groups with business models incorporating both broking (acting as agent for the customer) and insurer agent (including MGA) operations were more exposed because of their multiple roles. The subject of conflicts of interests was considered in more depth in [Conflicts of interests](#) on page 6/5.

Contractual obligations: In managing the facility, the broker is assuming additional liabilities under contract that include additional errors and omissions (E&O) risk, exposure to client default and non-payment of premium, the additional staff needed to operate the facility, and increased system costs.

Clash with insurers: The insurers not involved in the MGA will lose business as a result and may become less supportive of the broker in other areas or may even work against the broker.

Paul Anscombe, chief executive officer of Seventeen Group, which owns MGA Touchstone Underwriting, stated that a number of different drivers were behind the popularity of MGAs:

MGAs are often quicker to develop niche products that satisfy the broker market, whereas for some of the larger insurers it will take time to launch new schemes and products. They [MGAs] are more nimble and flexible and they're good at responding to specific sectors or schemes or needs for brokers ... When times are tough MGAs will struggle to get the capacity, particularly on a more specialist risk. But at the moment there's just so much capacity flooding into the UK market that it's easier for MGAs to get it.

Source: Axling, I. (2016) 'Brokers welcome swell in MGA numbers', *Insurance Age*, 30 June. Available at:

bit.ly/2qTQgeG.



Broking management decision: Forming an MGA

Regardless of the size of broker, how would you evaluate the pros and cons of forming an MGA to underwrite your portfolio of SME business compared with the other approaches such as using a scheme or a panel of insurers?



On the Web

A UK Managing General Agents Association was formed in 2011. You can find out more about it at: www.mgaa.co.uk.



F The impact of public opinion

Insurers are in the business of trust. They sell contingent promises to pay, more often than not at a distant point in the future. From a policyholder's perspective, the insurer's willingness and ability to fulfil these promises cannot be assessed until a claim is made. Clearly, for financial services in general, and for insurers in particular, the trust of policyholders and other stakeholders is a necessary condition for conducting business. Trust capital is primarily accumulated through corporate performance that consistently meets or exceeds stakeholder expectations. Building this capital is in a company's direct sphere of influence – as opposed to public perceptions as shaped, for example, by the media.

Source: Schanz, K-U. (2006) *Reputation and reputational risk management*. The Geneva Papers.



It takes 20 years to build a reputation and five minutes to ruin it. If you think about that, you'll do things differently.

Source: Warren Buffet, CEO of Berkshire Hathaway.



F1 What influences public opinion?

Public opinion, both private and commercial, and its impact on reputation are clearly important to the profession in many ways. Not the least is the attitude of potential applicants to join the sector. A pipeline of able people wishing to join our profession is essential for the future.



In the CII report, *What we talk about when we talk about trust: the future of trust in insurance and financial services*, the Executive Summary led with:

The perceived 'crisis of trust' and rise of public scrutiny

The idea that we are facing a 'crisis of trust' is not new. But the evidence is mixed, and some criticise the way trust is measured. What is more likely is that we have become more sceptical as a society, which is no bad thing, if it means we have also become a society of more active and capable consumers. Untrammelled trust, which is not properly grounded in a responsible level of consumer understanding, can be just as detrimental as unwarranted lack of trust – see, for example, the high confidence in mortgage and housing markets that drove real estate prices to unsustainable levels before the crisis. If we want consumers to be better informed and exercise greater responsibility, a discriminating attitude is essential.

The specific problem in financial services

While the 'crisis of trust' may not be as pervasive as doom-sayers would have us believe, there is a real, ongoing problem of distrust in financial services caused by the actual behaviours of some market participants, which has been exacerbated by the crisis and recession. Only time will tell how much damage has been done. Ongoing distrust could be crippling to the industry, to consumers, and to the economy as a whole.

Source: Chartered Insurance Institute (2010) *What we talk about when we talk about trust: the future of trust in insurance and financial services*. Available at:

www.cii.co.uk/media/850551/Trust_CII_2010.pdf.

A survey commissioned for the CII report made uncomfortable reading for insurers and brokers. It found in response to the question: 'How much trust do you have in the following financial and regulatory institutions?' that general insurers scored just 22% against 'a great deal/quite a lot', and 71% for 'not very much/not at all'. Brokers fared even worse, achieving only 12% for 'a great deal/quite a lot', and 78% for 'not very much/not at all'.



Sometimes, the profession does not help itself. To quote the CII report again:

The industry's poor image stems from behaviours that are perceived to fall short of acceptable standards in parts of the industry, including high profile and systemic product mis-selling, and associated deeply embedded negative views on the industry on the part of the media. As a result, consumer trust in the industry, and particularly confidence in investment and long-term savings products, has long been low. A survey undertaken for the FSA in 2005 found that 43% of consumers are not confident that financial products will provide for their long-term future. Compare this to other sectors: 90% of people are satisfied or very satisfied with the way doctors do their jobs.

Source: Chartered Insurance Institute (2010) *What we talk about when we talk about trust: the future of trust in insurance and financial services*. Available at:

www.cii.co.uk/media/850551/Trust_CII_2010.pdf.

The refusal of some travel insurers to provide cover following the volcanic ash cloud that affected aviation all over Europe in the spring of 2010 as the event was an 'Act of God' prompted this response in the press:

The Association of British Insurers said that the term 'Act of God' is no longer used in insurance contracts these days. However, several of the insurance companies I have contacted over the past few days used this term as an explanation of why claims won't be paid.

If your insurer uses this as an excuse to turn down a claim it is worth challenging. After all why should a volcanic eruption – a clearly explainable geological phenomenon – be credited to some higher spiritual being, when a flooded home, which surely could have some biblical precedent, is more likely to be blamed on underfunded flood defences.

Source: Simon, E. (2010) 'Volcanic ash cloud: insurers do use the act of God excuse', *The Daily Telegraph*, 23 April. Available at:

bit.ly/2ztTkRk.



The impact of any given event will be dependent upon what else is happening at the time. It is not unknown for governments and businesses to release news that is perhaps a little inconvenient (late on a Friday, say, when it might attract less media attention).

There seems little doubt that the media reporting of insurance issues is negative and confusing. For example, during the floods of 2007, despite the fact that insurers mobilised rapidly, dealt with claims that they did not insure, shared resources and made many instant payments, the media focus was on the relatively few claims that went wrong. During and after the 2008 financial crisis, the insurance profession was bracketed with banks despite the fact that in the UK, insurers did not need billions of government money to stay afloat.

Broadly speaking the general media, unlike the insurance trade or specialist business media, is more likely to run with a story if it affects private individuals. Although the Spitzer Affair received immense coverage in the insurance trade and business press, it received virtually no coverage in the general sections of the national press or on television.

Critical reflection

Why is the insurance profession so often confused with banks? Why do even experienced financial journalists confuse life and general insurance? What can and must the profession do to create awareness?



F2 How is this relevant to insurance brokers?

One response to general media coverage and the CII survey is a metaphorical 'shrug of the shoulders' in that they simply do not reflect reality. There is no obvious evidence that individuals or businesses are disaffected from buying insurance even if they do have a low opinion of it. Indeed 'compliance' in the UK, as measured by the proportion of private individuals and businesses that buy insurance, is very high. The exception lies in motor insurance where as many as 1 in 25 drivers have no insurance. But then the typical uninsured driver is unlikely to be motivated by a low regard for the insurance industry.

But while the survey and media may not reflect what people actually do, it does confirm a widespread perception of our profession. In many aspects of life, perception is reality.

The CII report refrains from attempting to set down a complete set of solutions to respond to this perception. However, it does propose the start of the debate based around increased professionalism, improved transparency and proportionate regulation, the encouragement of appropriate ethical behaviour and the delivery of the outcome expected by the profession's consumers.

On 4 March 2010 the Insurance Profession Task Force of the CII published the *Aldermanbury Declaration*. The Task Force, chaired by CII President at the time, Barry Smith, comprised senior individuals from the general insurance sector and spent many months shaping a common framework for professional standards.

A wide range of brokers and insurers have committed to implementing the declaration and this continues to be promoted as an industry standard.



On the Web

You can find more information on the CII website, which includes a list of the firms that have signed up to the declaration:

www.cii.co.uk/aldermanburydeclaration.



Broking management decision: Making principles public

Evaluate the benefits to your business of adopting a publicly stated set of business principles.



Critical reflection

While it may be easy to disregard the CII's research, it does reflect popular views. Therefore, consider what insurance and broking firms should be doing to change the mindset of both consumer and commercial clients.

F3 Chartered Broker status



Professionalism will prove a potent weapon in the battle to increase public and business confidence in the insurance market – and Chartered Status for firms of insurance brokers demonstrates a commitment to professional standards and philosophies. It recognises best practice, supports continuing development and highlights adherence to rigorous standards. It's a powerful way for a broking firm to sharpen its competitive edge.

Source: Radburn, M. (2009) *Stand out for all the right reasons*. Available at:

www.cii.co.uk/media/1641066/ib_brochure_2009.pdf.

In its leadership role to raise standards and to improve the perception of the insurance industry, the CII has introduced Chartered Status for individuals and firms including insurance brokers. Chartered Status is intended to raise standards within the profession and to achieve recognition from the public and businesses for these much higher standards.

Table 9.1: The benefits of Chartered Status

Sharpens competitive edge	Exclusive status gives holders an edge over competitors, both with consumers and with business partners, such as accountants/solicitors, who refer business.
Enhances business performance	Access to CII membership services will enhance staff knowledge and skill sets, improving their ability to work effectively.
Promotes and supports regulatory compliance	Chartered firms will inevitably develop a 'compliance culture' by adhering to the professional requirements inherent in maintaining Chartered Status.
Provides tangible evidence of professional status	Holders can use the Chartered marque on company signage, stationery and promotional literature, with certificates for display in all premises and a listing on a publicly searchable Chartered firm directory.
Helps attract and retain talent	Chartered Status is a clear indicator of the professional standing of a potential employer. Employees like to work for the best companies, and Chartered firms are viewed as 'best of breed' in their market sectors.



Applying for Chartered Broker status

There are three principal requirements to meet:

- meet the definition of an organisation carrying on business as an insurance broker;
- satisfy the eligibility criteria required of a Chartered firm both at application and on an ongoing basis; and
- pay an annual fee.

...The eligibility criteria cover a range of factors recognised as evidence of a commitment to professionalism. Six compulsory criteria must be met in full and a range of discretionary criteria makes up the remainder.

Fixed criteria

These six criteria must be met:

1. A minimum of one of the firm's board members must personally hold the CII Chartered Insurance Broker title.
2. One of the firm's board (who must personally hold the Chartered Insurance Broker title), must take on the role of Responsible Member. This person is the principal point of contact on Chartered status with the responsibility for the application, renewal and for any related issues at any stage.
3. The entire board, together with a minimum of 90% of customer-facing staff, must be members of the CII.
4. Access to a Chartered Insurance Broker must be available to customers.
5. The firm must have in place core values and business practices that align with the CII Code of Ethics.
6. The firm must have an appropriate professional development programme in place.

Variable criteria

The discretionary criteria work on a points basis, with a minimum of 50 points overall required.

Criteria considered	Points available
Percentage of board individually holding the Chartered Insurance Broker title (subject to the specified requirements Chartered titles from other awarding bodies will be recognised)	25–50
Percentage of board individually holding the CII Diploma in Insurance	10–15
Percentage of customer-facing staff individually holding the Chartered Insurance Broker title	10–30
Percentage of customer-facing staff individually holding the CII Diploma in Insurance	10–30
Percentage of customer-facing staff individually holding the CII Certificate in Insurance	5–15
Potential recognition of additional rationale to support the Chartered application detailing relevant processes which are not already included in the criteria above	5

Source: Chartered Insurance Institute: www.cii.co.uk



Critical reflection

Given the benefits set out in the text, what would a broker need to consider before applying for Chartered Broker Status? Include financial costs, benefits and competition in your considerations.

G Scenario 9.1: Centralising services

G1 Question

Currently for your global clients, administration is provided by individual client service teams. *Outline* the relevant considerations for a report if the firm wishes to consider centralising the provision of global service.

G2 How to approach your answer

- An analysis of the number of global accounts, the numbers of staff involved in servicing them and the costs incurred in doing so.
- The qualifications and experience of all the relevant staff.
- The potential for a member of existing staff to be selected as the leader of a centralised function or the costs of hiring a new leader.
- An estimate of the structure and cost of a new centralised team – in theory this should be less than the existing basis.
- The potential for the new team to service global accounts that are managed in other divisions.

The advantages:

- Efficiency from specialisation.
- Improved expertise.
- Stronger relationships with overseas network.
- More compelling new business proposition.

The disadvantages:

- Impaired service through lack of ownership.
- Risk that costs will increase.
- Reduced opportunities for service staff.

Self-test questions

1. What are the possible benefits of brokers organising themselves entirely around clients?
2. Summarise the reasons why insurers support MGAs and brokers with delegated underwriting authority.
3. What are the benefits of Chartered Status?

You will find the answers at the back of the book



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10

Financial security of insurance organisations

Contents	Syllabus learning outcomes
Introduction	
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E Monitoring the solvency of other brokers, MGAs and brokers with delegated authority	3.6
F Scenario 10.1: The security function	
Self-test questions	

This chapter relates to **syllabus section 3**.

Learning objectives

On completion of this chapter and your own private research, you should be able to:

- explain the analysis of the security of insurance companies and other intermediaries.

Introduction



Research exercise

Examine the history of insurer failures, such as the Independent and Chester Street, the circumstances surrounding the rescue of AIG Inc. by the US Government and the problems faced by the Irish insurer Quinn. Do you think that these events have had any effect on the way brokers view the security of insurers?

Insurers fail for a variety of reasons. Fraud is rare, although it lay behind the historical failure of the Independent in 2001. Occasionally, insurers can be overwhelmed by a catastrophic event such as the 9/11 terrorist attack. However, more often than not, the cause is a combination of rapid expansion combined with inadequate reserving and weak management.

The rescue of AIG in 2008 is something of a special case. As you will discover from your research, the AIG insurance companies were more than adequately capitalised. AIG Inc. was brought down by the Special Products division that was a spectacular casualty of the 2008 financial crisis.

It remains to be seen what the effects of the Covid-19 pandemic of 2020 will have on the financial stability of some insurers, particularly those writing business interruption insurance, and following the outcome of The Financial Conduct Authority's 'Test Case' *The Financial Conduct Authority (FCA) v. Arch et al.*

The traditional method of preventing failure was to require that insurers maintained an adequate margin of solvency. This is the excess of assets over liabilities after both have been adjusted in accordance with the various rules applying at the time. The purpose of the adjustments was to make sure that all liabilities were adequately recognised and that assets were diversified. The objective was to protect the insurer against both underwriting and investment risk. This margin is known variously as the **solvency margin**, **policyholders' surplus**, **policyholders' capital** or **net worth**.



Consider this...

Why do you think insurers hold more capital than that which is specified in the regulatory requirements?



Key terms

This chapter features explanations of the following terms and concepts:

Corporate governance	Minimum capital requirement	Own Risk and Solvency Assessment	Rating agencies
Security committees	Solvency capital requirement		

A EU Solvency II Directive

Solvency II Directive 2009/138/EC covers the capital requirements and related supervision for insurers. The key elements – the so-called 'framework' – were adopted in 2009, originally with a view to being implemented by Member States (including the UK) by 2012. This was then postponed until 1 January 2014, amended by **Directive 2014/51/EU ('Omnibus II' Directive)**, and it was finally implemented on 1 January 2016. Delays in implementation were a result of political pressure from various EU Member States.

The new Directive replaces 14 EU Directives and has been implemented in all 27 Member States plus three countries in the European Economic Area (EEA) to harmonise EU-wide insurance regulation. Solvency II is much wider in scope than **Solvency I Directive 73/239/EEC** and includes stronger capital requirements. The rules apply to all insurance and reinsurance firms with gross premiums over €5m and those in run off with provisions over €25m.

The rules are categorised into three pillars:

- Pillar 1 – quantitative. Based on calculations of capital requirements and investment management.
- Pillar 2 – qualitative. *Own Risk and Solvency Assessment (ORSA)* and supervisory review process (SRP).
- Pillar 3 – reporting and disclosure. The onus is on firms to develop systems for disclosure of information to the public, which can be accessed by regulators, analysts and *rating agencies*.

The main purpose of Solvency II is to ensure adequate policyholder protection in all EU Member States with all insurers holding capital calculated using the same methodology. It also takes into account current developments in insurance, risk management, financial techniques, international financial reporting and prudential standards. It is intended to better reflect the true range of risks faced by an insurer – an accepted criticism of Solvency I. Solvency II is also intended to recognise the fundamental differences between the risks of insurance and banking.

The Solvency II approach is very similar to that adopted by the UK regulators who piloted some of the concepts. It includes the following:

- *Minimum capital requirement* (enhanced version of that in Solvency I).
- *Solvency capital requirement* (compares to the enhanced capital requirement).
- *Own Risk and Solvency Assessment* (compares with the individual capital assessment).

Minimum capital requirement (MCR)

Like Solvency I the new regime specifies a minimum capital requirement (MCR), a critical level of capital below which a firm cannot be allowed to carry on its operations normally and stringent supervisory powers take effect. The MCR in Solvency II is intended to be a fairly simple calculation that can be undertaken and reported to the regulator on a quarterly basis.

The MCR is carried over from the Solvency I regime, but there will now be an absolute floor of:

- €2,200,000 for non-life undertakings, including captives, except for certain risk classes where it should not be less than €3,200,000;
- €3,200,000 for life insurance undertakings, including life insurance captives; and
- €3,200,000 for reinsurance, except for reinsurance captives where the MCR shall not be less than €1,000,000.

The MCR shall not fall below 25% nor exceed 45% of the undertaking's solvency capital requirement.

Solvency capital requirement (SCR)

A key feature of the new regime is a new solvency standard for all firms known as the solvency capital requirement (SCR; equivalent to the ECR). This will be calculated once a year, reported to the regulator and published. The firm is expected to continuously monitor its actual capital position against the SCR and also recalculate its SCR if the risk profile (e.g. the range of risks underwritten) of the firm changes significantly.

The SCR has to be covered by an equivalent amount of assets in excess of liabilities, subject to certain eligibility rules. If the SCR is not covered the firm must submit a recovery plan to the regulator.

Own Risk and Solvency Assessment (ORSA)

The ORSA requires every firm to produce a written report to the regulator providing an economic view of the capital needed to run its business, irrespective of the regulatory requirements. Additionally, ORSA provides a forward-looking perspective that should support the business strategy. The firm is expected to stress and scenario test the ORSA, and this in turn is expected to drive the contingency planning process.

A1 Expected benefits of Solvency II

Table 10.1 lists some of the expected benefits that the ABI suggested Solvency II would bring (while Solvency II is now in force, it will take some time to see the effects of it; at the time of print there have been some questions over unrated insurers and their ability to comply).

Table 10.1: Expected benefits of Solvency II (from the ABI)

Consumers	Solvency II should reduce the risk of failure or default by an insurer, with improved identification and monitoring of risk.
	A more consistent and open regulatory framework should make it easier for companies to sell across different markets, promoting competition.
	A more sophisticated assessment of insurers' capital should mean insurers are no longer required to hold excess capital, which increases costs and makes insurance and investment contracts more expensive than they need to be.
Insurers	The new regime will have a much greater focus on risk assessment and transparency, rather than arbitrary restrictions and excessive prudence.
	Market-based valuations of assets and liabilities will improve transparency and enable both firms and regulators to better understand the underlying financial position of the insurer.
	Solvency II will see a much greater role for firms' own internal risk capital assessments, including their own internal capital model, to provide a significant input to the regulators' assessment of firms.
	A more streamlined and proportionate regulatory regime should reduce burdens on insurers, therefore reducing costs and increasing flexibility.
Regulators	Regulators will have a better understanding of the firms they are regulating. The information they receive will more clearly identify the key risks in the business. This will ensure that regulators can take earlier action when risks emerge.

A2 Solvency II – conclusion

Solvency II is a complex undertaking. Insurers in the UK devoted considerable time and money in the run up to the adoption of this regulation. Some estimates put the total spent to date at over £500m.

Although many of the public statements were supportive, in practice the process of implementation was the subject of considerable lobbying both publicly and privately. As with any other EU venture, the national and international politics are complex. As a result, there were some significant changes, a dilution of the proposals and deferral of implementations.

The European Insurance and Occupational Pensions Authority (EIOPA) issued guidelines on how supervisors should act from January 2014 to January 2016 in preparation for Solvency II. The guidelines were based on Solvency II principles and focused on four key areas: systems and governance, assessment of own risks, submission of information and pre-application for internal models. Many companies adopted the full guidelines before the implementation date in January 2016.

Some insurers have found the new rules burdensome. Gibraltar's Financial Services Commission (FSC) ordered Enterprise Insurance Company to cease trading in July 2016 after it became apparent that the Insurer was insolvent and unable to arrange further funding. Gable, a Liechtenstein-based insurer ceased trading in December 2016 as it too became insolvent. Moody's Investors Service also reported a surge in M&As activity in the insurance sector in 2015 and 2016, reaching the highest level for many years. It doesn't appear to be a coincidence that this happened alongside the Solvency II implementation.

The large increase in reporting required by Solvency II has led to some companies merging to sit underneath a parent firm, meaning more-streamlined data analysis, although further casualties may occur as insurers must maintain the new required level of solvency.

The prospect of substantially increased capital that was proposed in the earlier versions of Solvency II could have had a dramatic impact had it been applied across the EU. However, it would have had minimal impact in the UK as insurers already comply with the higher standards maintained by the regulator. When the prospect of much higher levels of capital appeared real, many commentators saw this as the only way that the soft market cycle could be halted and even reversed. As it is, this threat has vanished and the market has returned to business as usual.

On the Web

The FCA updated its rules after Solvency II was implemented. You can read its policy statement at: www.fca.org.uk/static/documents/policy-statements/ps15-08.pdf.



Research exercise

Study the published statements of a selection of insurers from their websites on the subject of Solvency II to see how it has affected insurance companies. Trace how their views have changed over time and in line with key events, especially following implementation in January 2016, and any press surrounding the flexibility of meeting the solvency requirements. Additional information may also be found from the financial press, such as www.ft.com.



B The liability of brokers for insurer failure

In the case of *Osman v. Ralph Moss (1970)* it was held and subsequently confirmed by the court of appeal that the broker was liable in negligence for the selection of an insurer whose 'shaky financial foundation was...well known in insurance circles at the time'. However, this case was unusual as in most circumstances the broker is deemed not to be liable for the insolvency of an insurer.

For example, between 2002 and 2005, the Royal & Sun Alliance received much critical press and analyst comment (particularly about its asbestos liabilities) and was downgraded by the rating agencies. However, it continued to receive regulatory approval and kept an acceptable rating. Had the company failed in these circumstances, it is unlikely that brokers would have been found liable – although no doubt there would have been some tough conversations with clients.

However, brokers are under a general duty of care to use their expertise to select insurers that are suitable for their clients. This includes taking reasonable care in assessing the ability and willingness of insurers to pay claims. They also have to abide by the FCA's Principles for Businesses. Irrespective of what will happen in 'most' circumstances, all brokers have to approach this issue with a degree of circumspection.

The pressures on the larger firms can be particularly severe. The travails of AIG during the 2008 financial crisis, where a solvent insurer was owned by a parent that had been nationalised by the US government, proved challenging for brokers and the market.

B1 The consequences of insurer failure

The failure of an insurer is a distressing time for all concerned. While other insurers might express private pleasure at the failure of a competitor and the realisation of market rumour, an insolvency reflects poorly on the profession. For brokers, the very least outcome is a great deal of unpaid hard work.

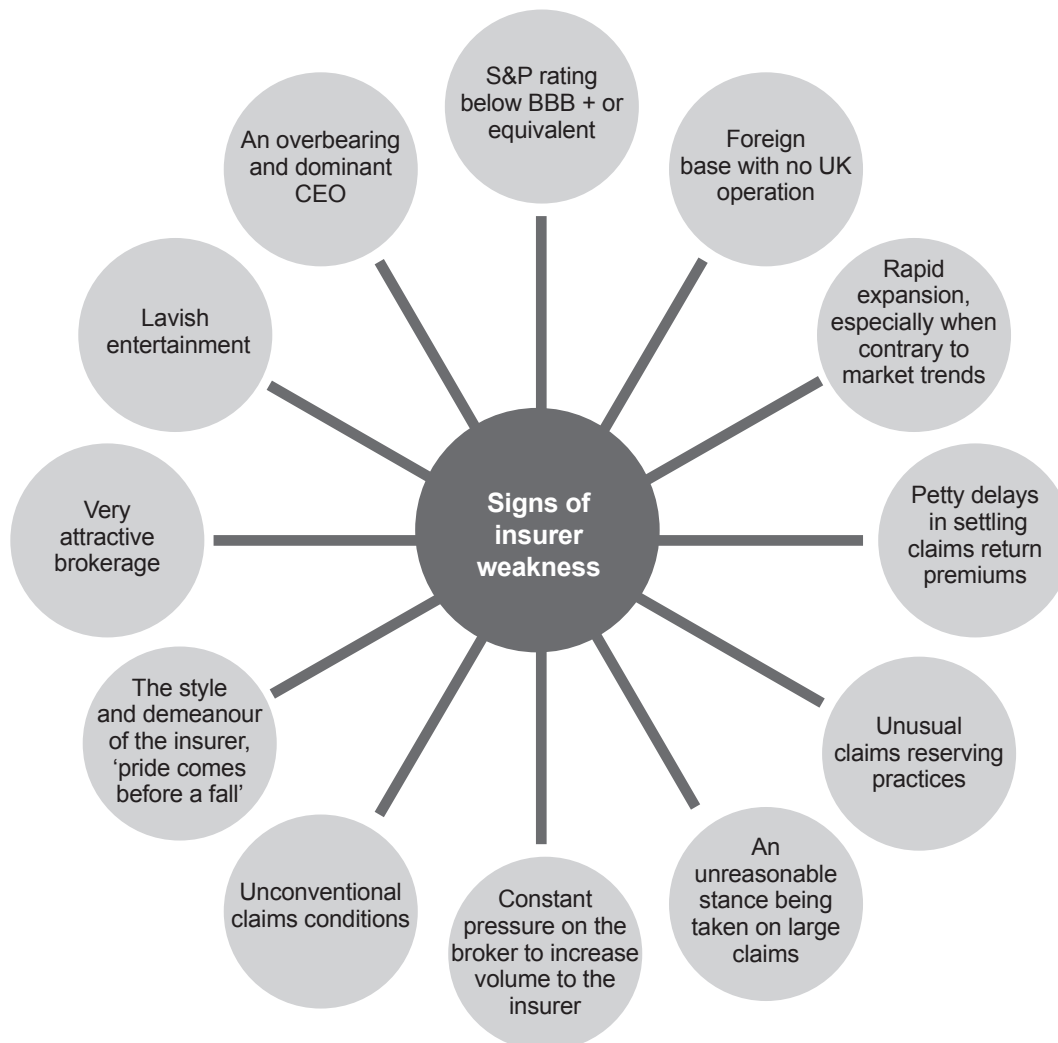
The Independent Insurance Company PLC was put into administration on 17 June 2001. It was one of the largest insurer failures in the UK. The Independent wrote over £1bn in gross premiums and operated in most market sectors. While it was an extreme case that, theoretically at least, is unlikely to be repeated due to modern regulation, it serves as a good case study of what happens when an insurer fails.

Table 10.2: The Independent: A case study

Stages	Commentary
The prelude	The Independent grew rapidly in the five years before the failure. The chief executive was a dominant and overbearing personality who interfered in every aspect of the business. Considerable pressure was put on brokers to place and retain business often with the personal intervention of the CEO. Staff were under intense pressure to grow the book. In the two years before the failure, it gradually became apparent that serious issues were developing with the claims service. Claims reserves became illogical. An example was very serious injuries reserved at £1. Claims staff were under pressure to apply low reserves. Many of the senior management team were unaware of the claims issues.
The failure	Many insureds were without cover for times varying between a day and, in some cases, weeks and months. When an insurer fails the replacement of risks generates considerable additional work for the broker, often unpaid. Premiums collected by the broker on the risk transfer basis become the property of the insurer even if the broker has not remitted the money. This obviously annoys insureds. Equally the brokers lose brokerage and many clients may refuse to pay fees.
The aftermath	Risks that have to be re-placed are generally done at higher, and in some cases punitive, premiums. This leads to client dissatisfaction and the need for further re-broking at renewal. Many clients refused to pay brokerage or fees on re-placed business, and became awkward over monies unconnected with the Independent.
Dealing with claims	Dealing with claims against insolvent insurers is much more time consuming. Additional work is placed upon the broker and additional stress on the client. Their administrators adopt a very legalistic approach in order to minimise the amount that the 'estate' is due to pay. In many cases, claim settlements may be for far less than 100%, often less than 20%. This makes the whole process even more frustrating and expensive for the client and the broker.
Reputation	Recommending an insurer that becomes insolvent can permanently damage a broker's reputation, even if there is no liability. Some clients sued brokers resulting in expensive defence costs. Insurer insolvency is excluded from brokers' E&O cover. The failure had a major impact on the reputation of the profession as a whole.

C Monitoring the security of insurers

The major brokers maintain specialist security departments that formally monitor the solvency of insurers. These are described below. Otherwise brokers rely on a combination of public information such as the ratings, their commercial judgment and their own experience.



The danger signs look obvious but they always do in hindsight. Just look at the experience of the 2008 financial crisis. In practice, brokers face a commercial decision. By not placing business with an insurer, the broker might risk losing a client or not winning a new one. The cost of this has to be weighed against the long-term cost of placing business with an insurer that fails.

Broking management decision: Security concerns

In a medium-sized broker, how would you persuade your senior colleagues not to use a given insurer when you have concerns over their financial security?



C1 The security function within large brokers

The larger broking firms choose to maintain their own security function for a number of reasons:

- **Client demand** – a frequent request in tender exercises for larger risks is indicative of the broker's approach to insurer security.
- **Large broking firms place business in many jurisdictions around the world** – the quality of regulation varies considerably from country to country and many insurers are not rated or only have public information ratings. For reasons of **corporate governance**, these firms prefer to adopt a consistent approach around the world based upon standards and procedures developed by a central security function.
- Many of the insurers that have failed in the UK and elsewhere did so while allowed to underwrite by the competent authorities, so **the broker needs its own method of assessment**.
- A perception among **large firms that they have a greater duty of care** imposed upon them because of their size, influence and access to confidential data.
- **The professional security function** can gain access to more detailed information from insurers.
- To undertake the necessary analysis requires financial expertise, and it is more cost effective to do this as part of a focused central team.
- In theory this function could be outsourced to a firm of accountants but that is unlikely to be acceptable to insurers, at least as regards the provision of confidential data.

C2 Composition and governance of the security committee

These committees generally comprise permanent staff who have the necessary experience and qualifications in the analysis of insurers' accounts, and in particular the techniques that may be used to improve the look of their numbers. Practitioners from the business who are involved in both placing and claims will join them. They will also be supported by other functions, such as the legal team. Some firms have an executive committee that makes policy decisions and meets less frequently. An operational committee supports this and will deal with the majority of 'routine' decisions.

C2A Corporate governance

Although detailed practice varies, most brokers set out explicit rules that govern the operation of **security committees**. These are to ensure that the committee operates truly independently and is not swayed by the many commercial pressures faced by brokers. These rules are likely to cover:

- **the Constitution of the committee** and the procedures for electing the chairman, executive and other members. They will be drawn so as to ensure balance of experience, expertise and fair representation from across the business;
- **minimum parameters** concerning the basic financial strength of an insurer. For example, a new insurer operating in the EU must have capital of at least £50m, or that the minimum acceptable rating is S&P BBB+;
- **the independence of the function** to ensure that its decisions cannot be overruled by the senior management of the company; and
- **procedures to avoid conflicts of interest**, e.g. rules to ensure that the chairman or other senior members of the committee are not involved in, or too close to, any given insurer.

C2B Analysis of information by a security committee

Table 10.3: Information of interest to the security committee

Information within the public domain.	Including annual returns filed with regulatory bodies, financial information provided by the insurers themselves (including the publicly available details of their reinsurance) and analysis and information from the major financial security institutions and the rating agencies, such as Standard & Poor's, Fitch and AM Best.
Confidential information from insurers for a better understanding of their strategies, including...	Methods of reserving, especially for long-tail liabilities.
	Specific treatment of reserves for asbestos, tobacco, environmental and other long-tail problems – particularly asbestos, in the light of the massive claims and litigation in the USA.
	How the reinsurance programme works and what the insurer's reinsurance buying philosophy is.
	How the insurer's control systems work, especially as regards control of underwriting and premium booking.
	A detailed analysis of the capital structure to ensure that the insurer has sufficient resilience in case of a shock event.
These meetings are particularly important when an insurer is suffering a run of bad news, particularly when its rating is downgraded. Unfortunately, much of the comment that appears in the press tends to be at best deeply critical and, at worst, factually incorrect. The meetings enable the analyst to gain the best view of the true state of affairs.	
Information gathered internally from within the broker about the performance of an insurer as regards...	Their willingness, as opposed to ability, to pay claims.
	Their speed of payment of claims and return premiums.
	Service levels, underwriting stance and flexibility.
The financial and strategic position of an insurer, including...	Its business position, e.g. characteristics of longevity, strength of competitors, competitive advantage.
	Its management reputation and strategy.
	Operating performance, individually and against its peers.
	Financial flexibility, e.g. ability to raise additional capital from internal and external sources and, as a corollary, the resilience of the company against unexpected events.

C3 Classification of insurers

Although frequent reference is made to 'approved' insurers, in practice brokers prefer not to use such terms as they may imply some form of guarantee. It is the function of regulators to 'approve' insurers. In classifying an insurer for use by the broker, it is saying that an insurer meets the minimum requirements alongside its peers and is equally likely to be able and willing to pay claims compared with other insurers.

Instead there will be some form of guide that states how and in what circumstances different insurers can be used along these lines:

- An insurer may be used on an unrestricted basis for any type of business that it chooses to underwrite.
- An insurer may only be used in a restricted fashion which could relate to:
 - geography;
 - types of business;
 - a requirement that the insured be provided with prescribed information about the insurer and acknowledges receipt of such information – this may include press releases, statements by *rating agencies* or the broker's summary of events affecting the insurer; and/or
 - a requirement that the insurer can only be used on express instructions from the client – this is only used where the broker does not wish to trade with the insurer.

C4 Challenges for the security function

Security committees face logistical and resource challenges in obtaining and managing quality, up-to-date information. A large broker will typically use thousands of insurance companies around the world.

Security committees can come under commercial pressure to consider insurers of dubious quality. However, such are the standards of governance and the abundance of acceptable insurers that this is a minor issue.

Security committees also face the same problems with uncertainty as anyone else. Ultimately, they have to rely upon a mixture of public, private and their own commercial evaluation as to whether an insurer's story 'adds up'. As with the *rating agencies*, there is little that can be done when fraud or deliberate misstatement by insurers happens. But this is as true of insurers as it is with any other business.

There is also the concern that an adverse decision by a security committee might cause an insurer to get into trouble, or get deeper into trouble than might otherwise have been the case had no action been taken.

There are cultural differences in attitudes between the UK and other countries. There is a perception that, for example, the French or German governments might be more willing to step in and help an insurer in difficulty, even if only commercial business is affected. This may lead colleagues outside the UK to feel that a committee based in the UK or the USA does not understand the value of this 'implied guarantee', and has overreacted to the 'temporary' difficulties faced by a specific insurer.

In a large and complex firm there will be different behaviour around the world. For example, a requirement that clients are provided with an information pack may be ignored in some countries. This differential behaviour could lead to the broker becoming liable for insurer failure, where otherwise they would not be.

In reality, the firm should not tolerate digression from agreed procedures. Better to review and, if necessary, change the procedures than run the risk of regulatory action or litigation as a result of the firm failing to comply with its own established procedures.

But the real challenge comes in the advice given to clients. For example, when a decision is made for a specific insurer to be used, the client must be provided with an information pack along with a letter that may seek instructions from the client. The likely reaction from the client is: 'Why is the information pack being issued, does the broker believe that there is a real problem, and what is the broker's advice?' Any suggestion of mid-term cancellation is often complicated by the lack of a cancellation clause, or an insurer's refusal to return a pro-rata return premium.

The insured faces the dilemma of either continuing with an insurer when there is some doubt about its ability to pay claims, or arranging alternative cover at additional expense. Where a policy has been cancelled mid-term, there may be awkwardness surrounding existing claims and a strict interpretation of claims notification conditions for losses that are reported after cancellation.

These problems can lead to accusations that, when it is most needed, the **security committee** cannot perform the very function that many staff perceive it is there for. Yet the broker knows that if it does not advise clients about potential issues it may face expensive, if ultimately fruitless, litigation.

These difficulties have to be set in perspective. Large broking firms know they cannot operate without a security function. In the UK the FCA, despite the fact that it sets no rules nor guidance applying to security committees, is likely to look askance at any large broker that does not maintain one.



Broking management decision: Considering security

Your firm has recently merged with another broker to create a business with national representation and a large number of commercial clients in the small- and medium-sized sector. At present there is no formal security function or guidance as to which insurers to use. You have been asked to look at the merit of a more centralised approach and specific guidance. Consider the issues that you will need to take into account.

D The role of rating agencies

Rating agencies began in the late nineteenth century in the USA. John Moody started assigning letter grades to American railroad bonds as an easier way for investors to understand the risks in the debt. The idea spread rapidly in terms of companies covered, but not in providers; one of the most powerful forces in capitalism has always been the preserve of a small club of bond-rating agencies led by Moody's, Standard & Poor's (S&P), AM Best and Fitch. By the 1930s US federal regulators started using them to evaluate other risks, including the safety of bank holdings.

Following the 2008 financial crisis, the reputation of rating agencies fell. They were heavily criticised for having given the essential AAA or equivalent rating to tranches of residential mortgage-backed securities, which turned out to be ill-deserved to say the least.

Consequently, many have called for more regulation of the agencies. In April 2009 the EU passed a directive promising to bring transparency and regulation to the agencies. At the end of July 2008 the US Treasury published its own reforms designed to bring about the same sort of overhaul, despite having introduced regulation of the agencies in 2006.

In 2014, the European Commission adopted a package of measures designed to apply 'stricter new rules' for the regulation of rating agencies.

Table 10.4: Things to know about rating agencies

Agencies have a wide range of 'good' and 'excellent' rating categories.	In S&P's 'A' range, which is considered to represent good or better security, there are seven grades between A– and AAA (the best), and nine if BBB and BBB+ are included. The BBB range is considered to be 'investment grade' by S&P, although most large brokers regard the minimum as BBB+.
Ratings do not represent a stately progression in terms of financial strength.	For example, an AA insurer may have capital strength that is equivalent to an AAA, but as a matter of practice, S&P will only give the highest rating to large and long-established companies. Note that none of the new Bermuda companies formed since 2001, despite being well capitalised, were given a rating better than AA in their early years.
Once downgraded, the rating agencies will expect exceptional performance before they will restore the original rating.	Typically they look for six to eight quarters of good results. This means the rating can understate the current strength of an insurer.
Ratings are about probability, not certainty.	Over time, a very small proportion of AAA rated companies will fail, with odds progressing upwards with the lower ratings. An A– company is theoretically ten to fifteen times more likely to fail than an AAA company. There are no guarantees: the Independent enjoyed an A– rating only months before its collapse.
Higher ratings do not make insurers better, just a better bet.	Some insurers simply do not want the highest rating. Among other factors, it requires very high capital that cannot be deployed in the business since it is there as a safety net, with the result that the returns to shareholders are diluted. For example, Munich Re once had a cherished AAA (S&P) rating. However, it has since decided that its current AA+ (S&P) rating is more than adequate.
Ratings are all about the ability to pay claims...	...as opposed to willingness, although the agencies will take account of claims service reputation.
Ratings are not all about financial strength.	All the agencies will consider a wide range of other factors, such as the quality of management, underwriting discipline, business franchise and so on.
Ratings can be 'interactive' or based on public information.	The former means that the insurer has met with the agency and has provided detailed information about its business. It also means that it has paid the agency for the rating. Public information means just that; based upon information in the public domain. The agencies cannot charge for these and they are diminishing in number.

D1 Do the ratings make a difference?

Theoretically, insurers with better ratings should be able to charge more or attract more business, but life is just not like that. Indeed it is a source of frustration for the insurers in the AA range that they cannot secure better terms. While a higher rating indicates more than capital strength, it does not mean that the insurer is immune from poor service or decisions that upset its clients and its brokers. Most brokers that run their own security functions will accept insurers in the A range and sometimes BBB+. Other brokers that do not have a formal process to assess security adopt a similar stance.

D2 BIBA Litmus Test Report

In December 2016 the BIBA launched a tool for its members, designed with analytical support and data from A.M. Best, to present a number of key financial ratios for a catalogue of unrated insurers most often used by BIBA members.

Steve White, BIBA Chief Executive said: 'At present there is no legal or regulatory requirement for an insurer to have a rating, nor is there a legal or regulatory requirement for an insurance broker to use only rated carriers and this online tool will give valuable support for our members when deciding whether the financial standing of an insurer they are considering placing business with is sufficiently robust or not.'

The BIBA Litmus Test Report will not give a rating to insurers in the same way as the well-known credit rating organisations. It provides financial ratios including underwriting, investment and reserve leverage percentages, as well as underwriting profitability and liquidity. The data is backed up by a number of detailed guides written by Litmus to help brokers interpret the numbers and make a decision about whether or not to choose that insurer.



Research exercise

Look at a list of the top 20 insurers in the UK, which you should be able to source from the insurance trade press. Compare the ratings of individual insurers with their ranking and growth or lack of it and consider possible reasons for your findings.

E Monitoring the solvency of other brokers, MGAs and brokers with delegated authority

When thinking about solvency, most people tend to think of insurers. In fact, there are many occasions when the financial security of another broker or an MGA is equally important. This arises because many risks are placed through schemes negotiated exclusively by brokers or with MGAs that may or may not be owned by a broker. So the broker needs to consider not only the security of the insurer but also the security of the broker or MGA.

Remember that most brokers and even MGAs have limited financial strength. Brokers' capital requirements under regulation assume there is no underwriting risk. MGAs are not regulated, although some choose to register with the FCA.

Therefore the main considerations for brokers are as follows:

- Is the MGA arranged on the risk transfer basis so that once money is paid to it, it becomes the responsibility of the ultimate insurer(s)? The broker should seek evidence of this arrangement which should be filed and checked regularly. This applies for brokers with delegated authority (DA).
- Does the MGA, or broker with DA, have the full authority of the insurer to act? A copy of this authority must be requested, kept on file and checked at suitable intervals.
- What is the underlying security backing the MGA? Would it be acceptable to the broker if the risk were being placed direct?

Requesting and checking the levels of professional indemnity limits is prudent when dealing with MGAs or brokers with DA.

F Scenario 10.1: The security function

F1 Question

You work for a large global broker that has just appointed a new CEO from outside the insurance profession. In their '100 day' review of the business, they have noted the cost of the global market security function and the fact that on a recent visit to an overseas office, they remarked that the security team was unrealistic in the way it approached its local market.

Compile the main points for a response to the CEO.

F2 How to approach your answer

Key points of content

You should aim to include the following key points of content:

Reasons for the security function:

- Client demand; a frequent request in tender exercises for larger risks is indicative of the brokers approach to insurer security.
- Large broking firms place business in many jurisdictions around the world. The quality of regulation varies considerably from country to country and many insurers are not rated or only have public information ratings. For reasons of corporate governance, these firms prefer to adopt a consistent approach around the world based upon standards and procedures developed by a central security function.
- Many of the insurers that have failed in the UK and elsewhere did so while allowed to underwrite by the competent authorities, so the broker needs its own method of assessment.
- A perception among large firms that they have a greater duty of care imposed upon them.
- The professional security function can gain access to more detailed information from insurers.
- Although there is no express regulatory requirement for a security committee it is almost certainly a de facto requirement under the Principles for Businesses, Threshold Conditions and SYSC.
- For similar reasons the firm could not be seen to be relying upon the rating agencies alone.
- To undertake the necessary analysis requires financial expertise and it is more cost effective to do this as part of a focused central team.
- In theory this function could be outsourced to a firm of accountants, but that is unlikely to be acceptable to insurers, at least as regards the provision of confidential data.
- In view of the nature of its work and the access to confidential data, the function needs to be independent of the rest of the business.

Further thoughts:

- A summary of the current staff and their costs.
- A review of the way the committee interacts with the businesses overseas. The 'difference in culture' argument will cut no ice in the event of litigation or an external audit of procedures by a regulator. New procedures and approaches may be necessary, rather than 'grumbling'.

Self-test questions

1. What is the Own Risk and Solvency Assessment (ORSA)?
2. Summarise four of the consequences of insurer failure.
3. Why do brokers prefer not to use the expression 'approved' in relation to insurers? Give examples of classification.

You will find the answers at the back of the book

11

Client services

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Introduction	
A Client buying behaviour	3.12
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C Defining excellent service	3.12
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H Risk-related services and solutions	3.16
I Scenario 11.1: Excellent client service	
Self-test questions	

This chapter relates to **syllabus section 3**.

Learning objectives

On completion of this chapter and your own private research, you should be able to:

- analyse how brokers provide excellent client service, including the management of the annual renewal cycle;
- analyse the role of brokers in claims and different approaches to claims service; and
- describe the scope of risk-related services.

Introduction

To be successful, brokers need to understand their clients' business, respond to their needs and wants, and deliver a good service. In this chapter we review the core elements of delivering these objectives.

It is necessary to understand the client's buying behaviour so that the client's needs can be responded to. It is essential to have a thorough understanding of the client's business, both to enable the right job to be done and to enhance the relationship. We look at how brokers can provide excellent service, the role of client TOBAs and the components of the annual renewal cycle. Finally, we review the various roles that brokers perform in relation to claims.



Key terms

This chapter features explanations of the following terms and concepts:

Claims advocacy	Hygiene factors	Key performance indicators	Lineslips
Retention	Service level agreements	Standard operating procedures	Terms of business agreements with clients

A Client buying behaviour

Attitudes to buying insurance vary. For some businesses, insurance is a distress purchase, only bought because it is required by law or because their bank, shareholders or customers require them to buy it. But most businesses see risk management and insurance as important to their business and will be interested in building relationships with their broker and their insurers.

Some clients want the lowest price all the time. Others are willing to take a longer view, are more appreciative of value, will respond to good service and do not necessarily want to expend effort in making frequent changes of broker or insurer.

Obviously, a large percentage of the personal lines sector is drawn by the advertising tidal wave promoting the wares of price comparison websites (aggregators) and direct insurers. Selling on price alone (or as the main driver) will hardly encourage loyalty and leads to relatively high churn. However, one-third of consumers choose to use a broker because their needs are too complicated for a direct/internet offer, they are not as sensitive to price or they prefer a more personal service.

So both the commercial lines and personal markets have different client buying behaviours. Of course, the world does not neatly divide up into price only buyers, value buyers and shades in between. Some are capable of exhibiting a variety of behaviours, especially during the course of a competitive tender or broker review. Brokers need to understand these different attitudes to ensure their success.

B Understanding the client's business

There are two key reasons why understanding your client's business is vital to your success as a broker:

Refer to

Refer to M81, section 5D2, for more on underwriting information. You can find this on RevisionMate.

- The broker can build upon and deepen the relationship with the client.
- The more that is known about the risk, the better the broking job that can be done, avoiding any exposure to errors or omissions (E&O).

You should already know from previous study, the value of good underwriting information and the benefits this can bring in negotiations with underwriters. Here we are concerned with how gaining a deeper understanding of the business can aid the relationship. See also the **Insurance Act 2015**, which places obligations on the client and broker to make a 'fair presentation' of the risk to an underwriter.

Most businesspeople are enthusiastic when asked to describe and explain their business. Remember, even in large corporations, people are proud of their firms and the role they play in the business. Entrepreneurs and proprietors are even more passionate about how their business works and what makes it a success. It is often difficult to get businesspeople to tell you about the negative aspects of their business.

It therefore follows that one way to strengthen the relationship is to have the fullest possible understanding of your client's business. This understanding must be broader than the knowledge you need to place the insurance programme. Your objective should be to become regarded as a trusted adviser with whom your client can discuss other business issues which may be confidential in nature.

It may be argued that there is no financial gain from this effort, yet as we will see there are real benefits to the broker. Research has shown that good relationships in business achieve a range of benefits (as shown in table 11.1).

Table 11.1: The benefits of a good business relationship

Reduced costs	Transaction and maintenance costs are reduced as a result of knowledge of how the client's business 'ticks'. Information flow is improved.
Better returns for the broker	The longer relationships last, the better the return for the broker. In all business relationships, higher costs are incurred at the beginning as the broker gets to know the client and its needs, but once this knowledge is fully assimilated, tasks of all types can be completed quickly and more efficiently.
More cross-selling	There is a greater likelihood of cross-selling or gaining a bigger share of the 'client's wallet' which simply means all of their insurance and risk-related expenditure including employee benefits; it is always easier to sell off the back of an established relationship.
Better retention rates	Good relationships equal long-term relationships that can sustain occasional mistakes and lapses in service, and indeed full-scale reviews. With a strong relationship, there is a good chance that if another broker proposes a lower fee or claims to be able to place cover at a lower premium, the incumbent broker will be given the opportunity to respond. Indeed the client may be willing to pay the broker a 'premium', that is, a higher fee in recognition of the value in the relationship.
Improved problem solving	Problems can be identified and dealt with before they become serious; even in the best relationships problems can occur for a variety of reasons; staff absence or changes might cause problems; the market or the client's needs may change; in this respect, clients can behave just like us – they don't like to complain and they are willing to tolerate faults. However, it is essential that the broker is always vigilant and regularly checks that the relationship is really as good as they like to think.
More referrals	If the most cost-effective source of new business is a new risk from an existing client, then the next best is a strong referral from an existing and satisfied customer.

Modern corporate governance practice requires larger businesses and for all of those in the public sector to review their service providers periodically. A good relationship cannot stop this, but it does improve the prospect of retention.

Personal lines and SME business transacted through price comparison websites, broker websites, call centres and through retail outlets present different challenges in terms of understanding the risks. The **Consumer Insurance (Disclosure and Representations) Act 2012** imposed a greater duty on insurers to ask specific questions as opposed to the previous duty on the policyholder to disclose all material facts.

Where an aggregator site acts for many different insurers, the challenge was to operate a question set that satisfied all their insurers without making the process too complex for the consumer.

B1 Insurance Act 2015

The Insurance Act 2015 (which relates to commercial insurance) abolished 'basis of the contract' clauses (as is already the practice for consumer contracts). Under the Act, a breach of warranty will simply suspend (rather than completely terminate) the insurer's liability under the contract until such time as the breach is remedied.

The insurer has no liability for any claim under the policy while cover is suspended, but once the breach is remedied, full cover under the policy is resumed. The Act also introduces 'fair presentation of the risk', which will require clients and their brokers to properly research and present relevant information relating to a risk.

The broker will also need to clearly identify why the client is buying insurance, and notify the insurer of any specialist activities their client undertakes and not just assume the underwriter would be aware of the activity. Brokers must clearly define which people at their client's company may have knowledge of insurance matters and include them in their fact-find.

A broker must also identify who at the insurance company is placing the cover and be aware of the underwriter's knowledge and experience. Brokers play an important role in this legislative change as clients would need assistance in providing this information. In terms of the client/broker relationship this potentially will reinforce the need for a broker. It may however remove the broker from offering a service for micro businesses or they may increase their fees to compensate for the in-depth work that will be required.

B2 Renewal transparency

In April 2017, new regulatory rules were introduced by the FCA which affected personal insurances. These rules require insurers and intermediaries selling retail general insurance products to:

- disclose last year's premium on renewal notices (accounting for mid-term adjustments where relevant);
- include text to encourage consumers to check their cover and shop around for the best deal at each renewal; and
- identify consumers who have renewed with them four consecutive times, and give these consumers an additional prescribed message encouraging them to shop around.

These changes have been introduced following an FCA consultation into concerns about levels of consumer engagement, their treatment by firms at renewal, and the lack of competition that resulted from this.

The consultation concluded that price increases were not transparent at renewal and that long-standing customers were paying more than new customers for the same insurance product. As a result, consumers often defaulted to renew products that were not good value or had become unsuitable for their changing needs.

These changes transfer the onus to the broker or direct insurer to demonstrate that they have undertaken a fair market exercise to establish the cover and pricing has been reviewed and is fit and fair for the consumer.

In 2017, admitting that the personal insurance market is 'dysfunctional,' then Aviva CEO Mark Wilson has vowed to introduce reforms to end the overcharging of loyal customers. 'The market is broken. I don't like it and neither do our customers,' Wilson said, as quoted by

the *Financial Times*. 'This dysfunctional market is a problem for the whole industry. And it requires an industry-wide solution.'

The Aviva chief made his comments after the Daily Mail ran an investigation into insurance overpricing and revealed stories of loyal customers who were supposedly ripped off by their insurers. This prompted politicians to call for a new code of conduct for the industry and heavy fines for insurers who fail to justify huge annual price hikes. The current Aviva strategy is to offer its loyal car and home insurance customers the same or better price at renewal as new customers and has been heavily advertising this number of TV commercials.

On the Web

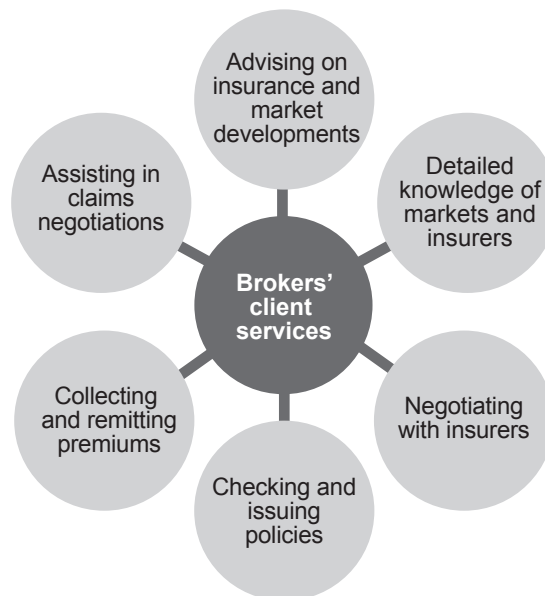
bit.ly/2q2emET.



C Defining excellent service

Research exercise

How does excellent client service benefit the firm providing it? Discuss with your colleagues and superiors how these benefits can be tangibly measured.



A broker needs to do all of these tasks well in order to provide good service. But many of these are merely '**hygiene**' factors. This expression comes from Frederick Herzberg's theory on job motivation. He established that certain elements of employment – the 'hygiene' factors – can cause dissatisfaction if missing, but do not necessarily motivate employees if increased.

What this means in practice is that most clients assume that it is the broker's job to check policies or to issue accurate documentation. In fact it has been discovered that while clients might not miss a policy being issued at renewal, if the document is subsequently sent to them months or years after inception they get quite upset.

So what does excellent service mean? Table 11.2 lists some examples.

Table 11.2: Service excellence

The client	Obtain a thorough understanding of the client's business and sector.
	Be aware of developments in the client's business and sector and understand how these affect the client and their impact on the insurance and risk management programme.
	Understand the client's buying and business style and be sensitive to changes that might affect it.
Broker-client relations and advice	Make sure that the client understands the Terms of Business and their obligations under them.
	Where relevant, for larger clients ensure that service level agreements (SLAs) are clear and adhered to by all members of the service team.
	Ensure that key performance indicators (KPIs) are reviewed and met.
	Plan for and advise the client of staff absences.
	Ensure that clients know both senior and specialist staff to help instil confidence in the firm's expertise.
	When a client asks a question about the technical aspects of cover that needs referral to the underwriter, anticipate the underwriter's response to avoid multiple conversations and request for information from the client. Respond promptly or give a realistic timescale.
	Plan fully for meetings with an agenda and supporting material. Follow up quickly with minutes and supporting material.
	Be willing to say no when appropriate.
	Prepare for problems: brief the client fully and make them aware of the options preferably without prompting from the client.
	Complete tasks within realistic timescales.
	Manage tasks through work in progress lists that are shared by the whole service team and reviewed regularly with the client.
	Don't allow situations to happen where the client is chasing for an answer – be proactive.
	Seek ideas on best practice, both internally and from other firms.
Image	Be prepared to undertake market exercises by having up-to-date market submissions.
	Adopt a professional approach.
	Develop a positive and proactive public image to instil confidence in the client.

D Terms of Business Agreements with clients (client TOBAs)

Refer to

Refer to M81, chapters 3 and 9, for more on consumers, ICOBS and risk management. You can find these on RevisionMate.

Traditionally, brokers relied upon very basic agreements with their clients. Often the only written agreement was the letter of appointment which only confirmed that the broker was appointed. The terms of the appointment and the scope of service offered were left to custom and practice. However, larger brokers would have had periodic letters of appointment signed by both parties with scope of the service and remuneration agreed.

Today all brokers recognise that their relationship with their clients required codification. Smaller firms tend to use standard agreements drafted by, for example, BIBA for the majority if not all of their SME clients. Larger brokers still use standard forms, normally of their own creation but often these are likely to be amended by larger and more legally minded clients and an agreement is made which stipulates the length, scope and cost of service provided.

Table 11.3: Reasons for TOBAs

External influences	Definition of the relationship
- Necessary to document an important business relationship setting rights, obligations and remedies. - Considered to be a feature of good governance and modern quality systems, e.g. ISO accreditation. - A requirement of professional risk and insurance managers at large companies. - The influence of procurement processes. - Influence of the FCA. TOBAs are not a regulatory requirement but the FCA consider them best practice. In effect this makes them mandatory.	- Definition of important areas of the relationship, especially claims. - Distinction between tasks performed by the broker, the client and the insurer. - Specifies the responsibilities of the client, especially to disclose material information. - Clarifies responsibilities of new brokers, e.g. in claims and processing premiums. - Supported by SLAs and KPIs for larger clients.

TOBAs for clients are not a requirement of the regulation. However, the FCA rules require the disclosure of certain mandatory information, and while this can be done via an Initial Disclosure Document, it suits many brokers to choose to include this information in a TOBA to prevent more proliferation of paperwork for the client. Therefore, it can be considered that in practice TOBAs are mandatory. All TOBAs must incorporate the information that the FCA requires brokers to give to their clients. For example, the client money rules (CASS) and the need to obtain the informed consent of the client concerning the use of non-approved bank accounts as required by the rule 5.5.41 of the FCA regulation.

Refer to

Refer to M81, section 4B2, for more on TOBAs. You can find this on RevisionMate.

In view of the diversity of actual wordings used, table 11.4 summarises the principal features of a TOBA.

Table 11.4: Principal features of a TOBA

Broker information	States the full name of the broker, confirms FCA regulation and sets out the broker's obligations in terms of the FCA Principles for Businesses.
Services provided	Self evident; needs to adhere to ICOBS where applicable.
Insurer security	States the disclaimer of responsibility for insurer failure.
Retention of records	States the broker's policy and has to recognise various statutory and regulatory requirements.
Claims	How they will be handled and the extent of the broker's responsibility, especially if the relationship is terminated.
Duty of fair presentation	Sets out the client's obligation to disclose material information and the consequences if they fail to do so.
Premium payment	Sets out when the client has to pay the premium(s) and methods available, including financing where applicable.
Broker remuneration	Sets out the basis for the broker's earnings. Some agreements will say that brokerage is '...earned for the policy period'. This is to protect the broker in the event that the client decides to cancel the insurance in whole or in part. Most clients, if they are aware of such a clause, are unlikely to accept it. This part of the TOBA should set out the broker's policy on disclosure of fees, brokerage and other income generated by facilities, overrides, referral earnings, insurer volume and profit share agreements. These are all described in more detail in the next chapter. Some brokers choose not to voluntarily disclose their income and some clients insist upon complete transparency.
Client money and bank accounts	To deal with the FCA requirements for disclosing how client money is treated, either through credit risk transfer via a statutory or non-statutory trust.
Cancellation of the agreement	Sets out cancellation rights of both parties.
Complaints	To whom they should be sent, how they will be dealt with and recognising FCA requirements, such as access to the FOS.
Money laundering/data protection	Statement of the broker's obligations under the law.

Table 11.4: Principal features of a TOBA

Law and jurisdiction	This is self-evident.
Lineslips and facilities	How they are used, disclosure of income and management of conflicts.
Use of sub-agents	To explain how and when sub-agents will be used and how they will be remunerated. Sub-agents may be used to gain access to a restricted or scheme market or to place cover in an overseas market where the main broker does not operate.
Insurers	The broker will provide a list of all insurers with which it trades on request.
Conflicts of interest	Explains how the broker will deal with conflicts of interest in accordance with FCA regulation.
Use of email	Confirms the legal status of emails, especially as regards requests to bind cover.
Instructions from	Defines who the broker will take instructions from, to avoid erroneous or fraudulent instructions being given by unauthorised personnel.
Limitation of liability	Traditionally, brokers had unlimited liability for financial losses arising from their professional services. In practice, their liability was limited to the sum of their E&O cover and the net worth of their business. For larger risks, this liability is disproportionate to the broker's typical earnings. Think of cover being arranged for an oil rig worth £500m where the broker's fee is £2m.
Duty to provide accurate information	Statement of the client's obligation to disclose all circumstances material to the insurance before it commences, throughout the life of the policy and prior to its renewal, including the consequences of any failure to make such disclosures.
FCSC compensation	What happens if the broker cannot meet its obligations due to insolvency.

To protect themselves, many firms now seek to limit their liability. This requires a procedure that ensures that limits are inserted in the TOBA and are discussed with the client. While most clients will accept the idea of a limit (since often they impose a limit of liability in their own agreements with customers and suppliers) there will need to be negotiation over the limit. Most brokers start at £3m and negotiate their way up through an approval procedure where no single individual can agree to a limit outside the standard; the highest limits require near board-level approval.

All such negotiations must be clearly recorded. Many brokers operate separate TOBAs for consumer/small commercial business and larger retail business, with the liability being limited in the latter but not the former.

Claims against the firm: following the decision in *Merrett v. Babb (2001)*, where an employee became personally liable after his employer went bankrupt, a clause may be included saying that any claim must be made against the broking firm itself, and not against an individual director or employee.

D1 Client produced TOBAs

Large clients, especially where a broker has been selected through a procurement process, now use their own contracts and SLAs. Some of the key features include:

Control of intellectual property – if generated by the broker, becomes the property of the client

Indemnity clauses – to be given by the broker arising from the performance of the contract

Insuring clauses – requires the broker to arrange the employer's/public liability etc.

Compliance – with employment and ethical standards

Exclusivity – the broker is not allowed to undertake work for another client in a related business

Non disclosure agreements – confidentiality clauses

Some of these terms may be unfair in the context of insurance broking and may impose liabilities that are disproportionate to the broker's earnings. Often agreements are specified in procurement exercises that are more applicable to entirely different work or services.

For example, a telecoms company contract is likely to include clauses on service or product testing, or 24-hour availability of emergency response teams that are inappropriate to an

insurance broking contract. The broker needs to exercise judgment as to what is and is not acceptable or what they can reasonably comply with.

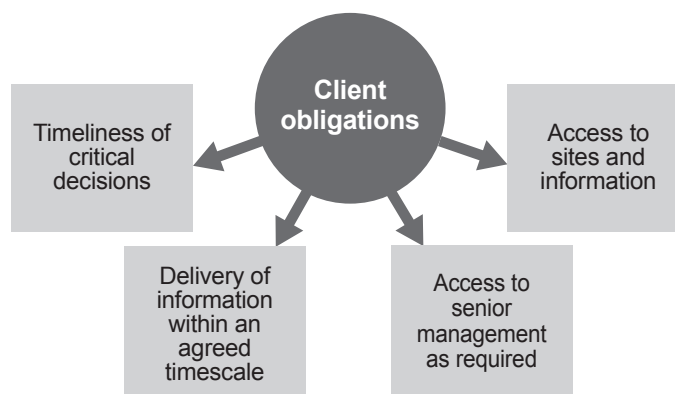
D2 Service level agreements (SLAs) and key performance indicators (KPIs)

Standard client TOBAs set out the range of services that the broker provides. Larger clients often demand and indeed larger brokers have for many years supplemented TOBAs with *service level agreements (SLAs)* and *key performance indicators (KPIs)*.

SLAs spell out what the broker will do in detail, who will do it and when it will be done by. Some typical features of an SLA will be:	A detailed description of the tasks that will be performed.
	Adherence to renewal timetables.
	Issue of relevant documentation to specified timetables.
	Arrangements for various meetings and the issue of minutes.
SLAs are supported by a range of performance measures also known as key performance indicators (KPIs) or key client outcomes (KCOs). They may include the following:	Within an agreed time frame: • Completion of the premium allocation under a global programme. • Issue of post-renewal documentation such as registers and invoices. • Planning for meetings, setting meeting agendas and the production of minutes after meetings. • Resolution of queries.
And...	
Bonuses and penalties for meeting or failing to meet KPIs/KCOs.	Stability of the service team with a commitment not to make changes without the agreement of the client.
Conclusion of renewal within a specified time, say 30 days before the renewal date.	Achievement of required capacity or limits for the insurance.
Achievement of enhanced cover.	Premium savings.
Specification of the service team.	Successful negotiation of claims.

D3 Client obligations

Balancing the broker's service obligations with the obligations of the client.



E The annual renewal cycle



Insurance is one of the few businesses where our clients are invited to sack us every year!

Source: David Martin, former CEO of Willis UK

Most general insurance policies are issued for a twelve-month period. Even when a long-term agreement applies, there is normally some form of annual review option for the insurer and occasionally, the client. Thus, the broker needs a process that ensures that the renewal for each client is dealt with in a timely and efficient fashion. The key features of this process comprise the following:

Diary system for renewal prompts	Systems include triggers for activity, e.g. requesting up-to-date claims data.
Reminders	With respect to adjustable policies.
Annual service plan	Records details of tasks to be performed throughout the year.
Open items list or work in progress	To record all current outstanding tasks, responsibility for completion and deadline.
Stewardship reports	Mid-term review of performance by the broker, essential to the service commitment.
Registers	Summaries of policy cover; details of each policy, contact names, claims procedure etc., disclosure of earnings and client warning on disclosure of material information.
Renewal report	Presents terms with a comparison with the previous year, describes the renewal exercise and makes recommendations.



Consider this...

What will presentations to underwriters need to look like and what differences will brokers see due to the Insurance Act 2015?

The challenge for all firms large and small is how to ensure that these procedures are followed consistently for all clients and by all service teams. Management of the process could include:

Proprietary and bespoke IT systems – These are widely deployed by all brokers. Most modern systems perform basic tasks such as managing renewal lists and flagging overdue actions, as well as more sophisticated jobs such as assisting market selection and producing underwriting submissions. Larger organisations will build their own system or adapt an off-the-shelf one, whereas smaller brokers may have to use the market offering, which may not provide the overall solution they require.

Standard operating procedures (SOPs) – This is simply a statement that codifies all of the processes described above and explains ‘how things are done around here’. These should be an important part of new employees’ induction and current employees’ appraisals.

Regular audit – Compliance with the SOPs should be tested by a process of self-assessed file reviews and internal audit by a separate function.

Adequate supervision – All work must be overseen by either more senior staff or through senior staff working in groups where the quality of work can be challenged.

Monthly reporting at senior level – A ‘red, amber, green (‘RAG’)’ or ‘heat’ chart can be used to highlight good and bad performers and indicate the need for action.

The above procedures relate mainly to commercial cases where the income exceeds a certain threshold (this may be £5,000 income to the broker). For smaller cases and/or where there is just one policy, standard renewal letters are used. The letters must contain all the regulatory disclosures, meet ‘contract certainty’ requirements and be issued ‘in good time’ to allow the client to consider the proposals and make enquiries in the market if appropriate.

F Client satisfaction

In the past **client satisfaction** was monitored fairly informally. Typically, it would be based upon discussion with the client by their account executive or a more senior manager. However, many larger brokers have adopted techniques used in other industries to review regularly their clients' satisfaction on a regular basis. This is done by online or written surveys using standard question sets to ensure consistency. This task may either be done by the firm itself or with the assistance of outside specialist marketing organisation.

This process may be supplemented with structured interviews with the clients conducted either by the firm's own personnel or outside specialist. Preferably, these interviews should not be done by the teams directly involved in the subject accounts.

This is comparable with the internal stewardship report mentioned in the diagram above. However, this technique can be better at identifying difficult issues. A good example, and often the most difficult, is a personality or style clash. Many businesses use both techniques.

There are a number of benefits to monitoring client satisfaction, which include:

- early warning of any problems that the client is having with the broking service, allowing the broker time to address them;
- an improved relationship with the client and the demonstration of the broker's interest in their views; and
- identification of any overall areas of strength or weakness, across all clients. Trends can be identified and used as part of the regular rhythm of managing reporting.

Perhaps one of the classic problems is the personality or style clash between a senior member of the broker's team and the client. Frequently this is obvious to everyone except the senior member.

Of course, no approach is perfect. One of the challenges, especially if surveys are conducted by email, is getting clients to respond. If the response rate is too low, it may create false reports. Those clients with issues are more likely to complain. You should also note that this type of feedback process is not a substitute for the complaints procedure that firms' must maintain under the regulation.

G Claims

Refer to

Refer to M81, sections 3I and 8A2, for more on ICOBS 8 and claims handling

You should already be familiar with the regulation in this area. However, as a reminder, the express regulation is limited to ICOBS 8.3. This says that:

- a broker is expected to comply with the general law applying to the duties of an insurance intermediary;
- a broker must take the appropriate steps to avoid conflicts of interest, particularly where it is acting for both the client and the insurer; and
- where a broker does not have the authority to deal with a claim, it should forward any claim notification to the insurer promptly, or inform the client immediately that it cannot deal with the notification.

In all other respects, in dealing with claims a broker must observe all other relevant aspects of the regulation, including compliance with the Principles for Businesses, the fair treatment of customers, the avoidance of conflict of interest and so on.

Despite the fact that ICOBS does not apply to 'large' risks, in practice the FCA expects brokers, especially the larger firms to act as if ICOBS did apply.

G1 The broker's role in claims

Where a broker receives brokerage or commission for arranging a policy, by custom and practice and derived from the law of agency, the broker is responsible for handling claims irrespective of when a claim is made or whether the policyholder is still a client of the broker. In addition, brokers placing risks in Lloyd's and the London Company Market have a specific responsibility to appoint adjusters, negotiate claims on behalf of their clients, and collect claims payouts from the subscribing underwriters.

So this is a statement of the conventional position. The question is what happens in practice and what are the market drivers that affect the behaviour of brokers with respect to claims?

Table 11.5: The claims services offered by brokers

The traditional full service role: all claims are notified to and handled by the broker who negotiates with insurers, collects the claim and sends the cheque to the client; this is often known pejoratively as a 'postbox' service.		No role at all where all claims are notified direct to the insurer.
The consultative or claims advocacy role: the majority, if not all claims are notified direct but the broker undertakes some 'added value' services.	Examples of 'added value' services are: - managing the quality of insurer and adjusters' claims' service; - reviewing reserves and removing duplicated and incorrect entries from claims listings; - analysing claims data and providing appropriate reports to the client; - providing detailed advice and consultancy on large and complex claims; and - providing bespoke or standardised claim recording and analysis software and systems.	The claims principal role: the broker takes full or partial responsibility for negotiating and settling claims under a delegated authority from either the client, where they are self-insured, or the insurer.

Some brokers employ experienced loss adjusters to help the client prepare the claim and negotiate with insurers. Their costs may be absorbed as part of the overall service to clients or, more typically, are charged at a specific fee – based on time spent or a percentage of the loss settlement.

G2 How does the broker decide what claims services to provide?

Attitudes vary widely across the profession. In deciding the level of service to offer, a broker must consider their relationships with both their clients and the insurer:

Relationship with clients	Relationship with insurers
- Are they willing to pay for their broker to provide the claims services? - If the broker does not provide a claims service, does this represent value for money for the client? - How will they react when they are advised that their claims will be handled by the insurer? - If the broker is not involved, how will the quality of claims service be managed and maintained? - If other brokers promise to provide the service, is this a competition issue?	- Will the broker's handling of a claim adversely affect their (potentially considerable) investment in systems and processes to provide instant responses to claims? - How does the decision about claims handling affect the drive to reduce the cost of both handling claims and final settlements?

What is the standard of claims service provided by the insurer? Can the broker identify good and bad service and select insurers accordingly to maintain the satisfaction of clients? Where claims are dealt with direct, what processes does the broker have in order to monitor insurance claims performance?

The role chosen by the broker varies with the size of the firm. Smaller brokers believe that negotiating claims on behalf of their clients is an essential part of their service. They might also be sceptical about the quality of insurers' claims service and see personal involvement

by way of *claims advocacy* as the only way to control this. The broker may also have specialist knowledge of an industry, over and above that of the insurer, and possess the technical skills and ability to deal with a claim more efficiently than the insurer.

However, most brokers recognise that often there is little value in being directly involved in most motor and the majority of liability claims. This requires them to find other ways to monitor the insurer's claim service.

Larger brokers generally avoid the '**postbox**' approach preferring to concentrate on higher 'value added' services. Most of the firms placing London Market business maintain quite substantial claims resources both to manage the process of collecting claims from the large number of insurers and reinsurers that may be involved in a single risk and to provide specialist advice to their clients.

There are three further considerations for brokers. First, what happens when a client is lost but there are claims outstanding or claims arise after the end of the broker–client relationship.

As stated at the beginning of this section, where the broker receives commission, there is a continuing obligation to handle claims even if they are notified long after the relationship has ended. The broker either has to build in this expense as an overhead or ensure that the terms of business agreed with the client make explicit provision for these circumstances.

Second, there are the issues connected with long-tail claims that may be made 10, 20 or 30 years after the policy has expired. These are often connected with insurers that have become insolvent or have ceased trading and are in what is known as '**run-off**'. An example of the problem is the long-running litigation concerning mesothelioma, a cancer of the pleura of the lungs that can have a latency period of up to 40 years. Not only have many of the businesses that employed the affected individuals gone out of business, but a significant proportion of the claims are with insurers such as Chester Street that are insolvent.

In these cases, many brokers have themselves ceased trading or been acquired and merged such that records have been lost or destroyed.

A third consideration is where policies transfer from one insurer to another with outstanding (or new) claims being handled by a previous insurer. In such circumstances, many insurers will not continue to hold client review meetings and are less willing to continue to provide run-off reports to the broker or client. By handling the claims in-house, the broker retains up-to-date information on all claims, making the risk more portable between insurers.

Research exercise

What kind of services comprise claims advocacy? Consider the procedures a broker would need to set up to perform these services effectively.



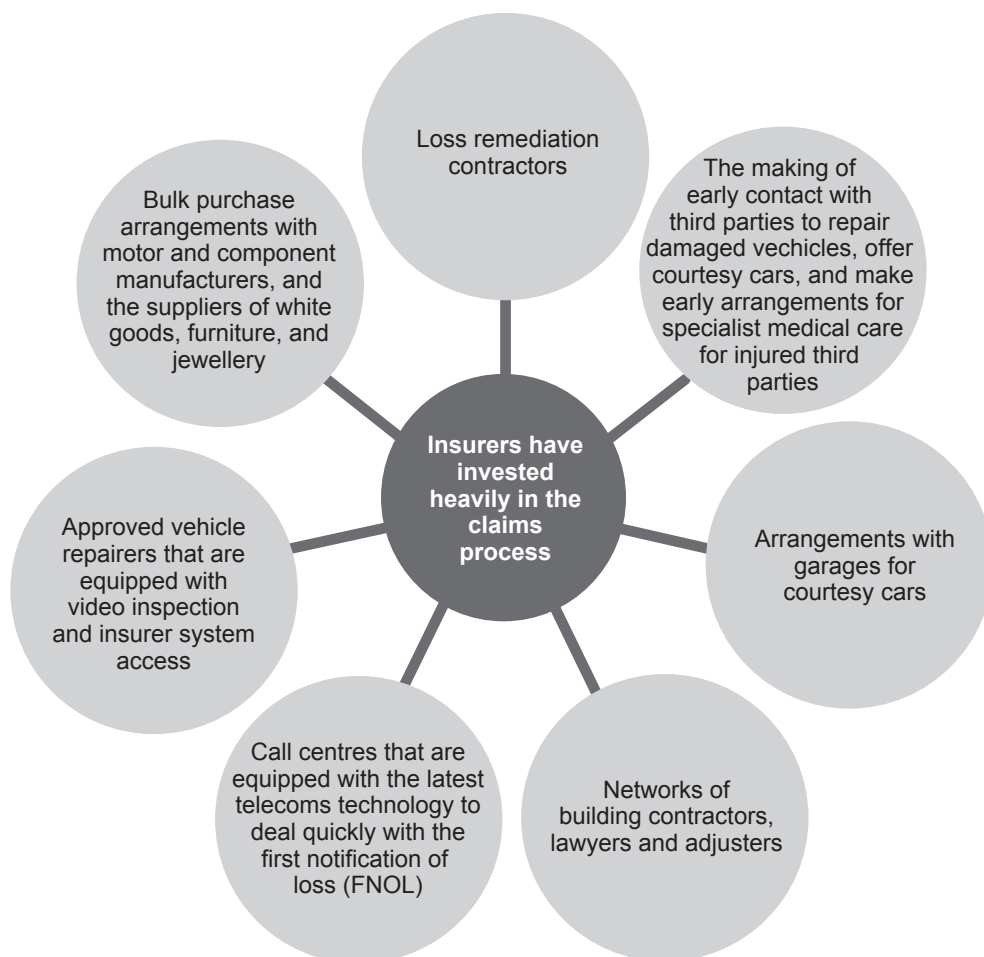
Broking management decision: Cost assessment

In the past, many claims services might have been provided automatically. However, everything costs money and brokers need to ensure that the cost of providing these services is recognised by and paid for by the client. How can the broker achieve the correct remuneration for the services provided?



G3 Insurers

Insurers naturally regard their claims service as their shop window. It is the area where what is otherwise merely a promise to pay becomes reality. Many insurers are reluctant to delegate authority to negotiate and settle claims, especially when they are fully responsible for the cost of claims. Where the insured is taking a high degree of self insurance they are normally more willing to delegate authority to either the client, the broker or other specialist claims-handling service providers such as adjusters.



For this reason, insurers prefer all losses to be notified to them direct. They will argue that their process delivers better service this way and that the broker adds little value. Moreover, liability claims protocols overseen by the courts and the Ministry of Justice impose extremely strict timelines on insurers to acknowledge and investigate liability claims. Insurers argue that here, brokers merely 'get in the way'.

The exceptions tend to be:

- property claims for larger insureds where there is often a preferred adjuster to whom claims will be notified;
- employers' liability and public liability claims where many larger clients arrange contracts with specialist law firms or adjusters and have their own processes for early intervention into bodily injury claims and into customer complaints to prevent them turning into insurance claims; and
- own damage losses on large motor fleets where a variety of service providers offer a package of services in addition to or alongside leasing and maintaining vehicles.

In household claims, competition among adjusters has been intense for the large bulk claims-handling contracts. This means that, in order to maintain service protocols, they also prefer to deal directly with the claimant.

In addition to the investments in process as previously described, insurers also have a huge investment in the expertise of their claims negotiations staff, and often regard this expertise as being a differentiator.



Critical reflection

Among the larger brokers there has been a drive to move claims to direct deal for reasons of economy and service standards. Has this reduced or improved client service?

H Risk-related services and solutions

Refer to

Refer to M81, chapter 9, for a detailed look at the wide range of risk assessment facilities brokers offer. You can find this on RevisionMate.

There is much business school theory to support the concept of **cross-selling**. This occurs when, for example, a bank that provides your current account offers you household insurance, or your gas supplier offers electricity. The ideas that support this theory include the following:

- It is less expensive to sell to an existing customer than to find an entirely new one.
- It is easier to access existing customers.
- Multiple points of contact with clients make them 'stickier'; that is, they are more reluctant to change provider.

Smaller brokers tend to concentrate on providing good advice to their clients for their personal and commercial insurance needs. Larger broking firms offer a very wide range of additional services. Generally, these are provided for a separate fee although sometimes they may be wrapped into the overall fee. Table 12.3 describes a selection of **risk-related services**.

Table 11.6: Risk-related services and solutions

Claims services	Risk management	Analytical services	Other services
Where claims are notified directly to, negotiated and settled by the insurer ('direct deal'): The monitoring of insurer service, regular reviews of claims and reserves, problem resolution and data analysis.	Consultancy on risk engineering such as the installation of sprinklers or security systems.	Claims analysis to show trends and for selecting deductibles.	Political risk consultancy.
Handling claims as a principal – where authority to settle claims is delegated to the broker by either the insurer or by the insured where claims are self-insured.	Property surveys to assess physical hazards such as fire, flood and to assess estimates of maximum possible losses from an insured event and to identify possible risk management options.	Actuarial analysis.	Security services associated with people travelling to hazardous areas.
Large loss consultancy particularly for: • large business interruption claims; • claims disputed by insurers; and • complex liability or D&O claims.	Property risk benchmarking using a variety of 'heat map' (e.g. 'red, amber, green') systems to compare and contrast different risks either within the insured's own business or across an industry sector.	Dynamic risk analysis using actuarial and probabilistic modelling to assess value of different retentions and layers of cover.	Property valuations.
Motor damage claims management – although few brokers provide this service in view of the competing offerings from fleet management companies and the investment required in systems and networks of garages.	Business interruption surveys to assess to correct sums insured, maximum possible loss and to identify possible risk management options.	Risk retention analysis to establish the insured's ability to self-insure risk.	Premium finance.

Table 11.6: Risk-related services and solutions

Claims management software systems designed to record full details of all applicable claims and produce relevant reports and statistics.	Supply chain analysis to assess and manage exposures to suppliers of raw materials, components and utilities such as electricity and to customers in a similar vein with the purpose of analysing exposures and risk management options.		Contract risk management in relation to insured and uninsured exposures.
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The larger and global broking firms will provide a wide range of these risk services from their own resources, whereas smaller firms tend to work with specialist contractors. Large clients may prefer to access some specialist services themselves, but when they are buying the majority from the broker the client benefits from being able to source a comprehensive risk financing and management programme from one place. The broker widens and deepens the relationship, increasing revenue and longevity.

What all brokers have to recognise is the difference between the services that a client expects to form part of the broking service and those services that are genuinely additional. An example is claims analysis. If the client has a self-insured programme, claims analysis is an essential part of evaluating the benefit of that type of programme compared with a conventional approach.

Further, where a broker is acting as an introducer for a third-party provided service (e.g. premium finance) and receives payment for this, they need to consider making the appropriate disclosure to their client.



Research exercise

Review the list of risk-related services described above, and look for any others that brokers of all sizes may offer to their clients, either through their own resources or by arrangements with contractors and other service providers.



Broking management decision: Selling extras

Why would you wish to sell or provide additional risk-related services to your clients in addition to the standard insurance broking functions?

I Scenario 11.1: Excellent client service

I1 Question

Following the loss of a key client and the discovery that the firm's client retention rate has dropped below 90%, you have been appointed as director of client service and retention.

One of your first tasks is to address account executives and directors on raising standards and delivering service excellence. *Summarise* the key issues you need to cover.

- Ensuring that the client fully understands their obligations.
- Ensure the client knows a wide range of staff.
- Adopt a professional approach.
- Deal with technical questions efficiently avoiding repeated questions to the client.
- Plan for meetings and follow up quickly with minutes and supporting material.
- When problems arise, plan solutions and options without prompting from the clients.
- Complete tasks within agreed timescales.
- Use a work in progress list to manage more complex tasks especially on large accounts.
- Set realistic client expectations.
- Don't let situations develop where the client has to chase the broker – be proactive.
- Be ready to respond to urgent needs for re-marketing by keeping underwriting data and submission up to date.

- Implement a formal client feedback process to obtain impartial feedback on all aspects of the firm's service. The benefits are:
 - Early warning of issues that cause dissatisfaction.
 - An improved relationship with the client and the demonstration of the broker's interest in their views.
 - Identification of any overall areas of strength or weakness, across all clients. Trends can be identified and used as part of the regular rhythm of managing reporting.

I2 How to approach your answer

Key points

You should aim to include the following key points of content:

The components of excellent client service

- Understanding the client's business enables the broker to:
 - Reduce transaction costs.
 - Maintain a long-term and therefore more beneficial relationship.
 - Improve retention.
 - Resolve problems quickly.
 - Create more referrals.
 - Respond to changes in the business more rapidly.
 - Deliver against client expectations.
 - Be seen as a trusted adviser.
 - May have more suitable knowledge and expertise to handle a claim on behalf of the insurer.
- Ensuring that the client fully understands their obligations.
- Ensure the client knows a wide range of staff.
- Adopt a professional approach.
- Deal with technical questions efficiently avoiding repeated questions to the client.
- Plan for meetings and follow up quickly with minutes and supporting material.
- When problems arise, plan solutions and options without prompting from the clients.
- Complete tasks within agreed timescales.
- Use a work in progress list to manage more complex tasks especially on large accounts.
- Set realistic client expectations.
- Don't let situations develop where the client has to chase the broker – be proactive.
- Be ready to respond to urgent needs for re-marketing by keeping underwriting data and submission up to date.
- Implement a formal client feedback process to obtain impartial feedback on all aspects of the firm's service. The benefits are:
 - Early warning of issues that cause dissatisfaction.
 - An improved relationship with the client and the demonstration of the broker's interest in their views.
 - Identification of any overall areas of strength or weakness, across all clients. Trends can be identified and used as part of the regular rhythm of managing reporting.

Self-test questions

1. Summarise four of the benefits of good client relationships.
2. Summarise the reasons for client TOBAs.
3. Why should a broker manage client satisfaction?
4. What are the considerations for a broker when deciding what claims services to provide?

You will find the answers at the back of the book

12

Broker remuneration and transparency

Contents	Syllabus learning outcomes
Introduction	
A How brokers get paid	3.15
B How fees are calculated	3.15
C Transparency	3.15
D Scenario 12.1: Fees v. brokerage	
Self-test questions	

This chapter relates to **syllabus section 3**.

Learning objectives

On completion of this chapter and your own private research, you should be able to:

- examine avoiding and managing conflicts of interest as they relate to broker remuneration and transparency;
- review the approach brokers need to adopt in treating their customers fairly in relation to remuneration and transparency; and
- analyse the way in which brokers are remunerated.

Introduction

It is believed that the first brokers became active in the UK in the fifteenth century, placing marine insurance. This was before the arrival of an established location such as Edward Lloyd's coffee house where 'underwriters' habitually gathered. Therefore, the first brokers not only had to have good contacts with the wealthy merchants that underwrote marine risks, they also had to know where to find them.

The process of completing a 'slip' for a marine insurance could be very time-consuming. As a result, brokers charged fees for their services.

It was only with the development of insurance companies and the growth in demand for other insurances that accompanied the industrial revolution (such as cover against fire), that insurers started to appoint agents and pay them a commission for the introduction and renewal of business. By the mid-nineteenth century, with the arrival of the joint stock companies or public companies as we now know them, brokerage or commission became the standard method of paying brokers.

However, in the UK, the majority on non-SME commercial business is on a fee basis. The exception is international business, where brokerage remains common.



Key terms

This chapter features explanations of the following terms and concepts:

Brokerage	Carrier service agreements	Commission	Contingent commission
Fees	Overrides	Risk-related services	Transparency

A How brokers get paid

Today, brokers can earn their income in the following ways:

- **Commission or brokerage paid by insurers:** rates can vary from as little as 2.5% for employers' liability through to 15–30% for property, 25–30% for property-based packages, as much as 40% for lines such as personal accident and special contingency risks and 50% for real estate business (although much of that commission is rebated to landlords). At the height of the consolidation of smaller brokers from 2003 to 2008, some of the leading firms were rumoured to get 45% or more for commercial package business.
- **Additional brokerage** for subscription risks placed in the London Market to defray brokers' costs in collecting premiums, preparing policies and handling claims. Work transfer fees are also paid outside of the London Market, particularly where the broker has a formal partnership with panel insurers.
- **Fees paid by clients.**
- **A variety of administration and policy fees:** initially applied only to SME business where the brokerage earnings may be low. Policy and administration fees have now been introduced more widely, and are also charged to larger commercial clients.
- **Overrides** (or **contingent commissions** as they are also known) and other supplemental payments made by insurers. These payments are normally made on an entire account basis and may vary from a straightforward percentage of premium throughout to enhanced payments based upon growth and profitability of the account. The scale of these payments can vary upwards from 2% of the premium, whether on a brokerage or fee basis.

It is not clear when this practice started. Insurers have traditionally defrayed brokers' costs through payments known quaintly as postages, but these were never of the same order as overrides. There is some suggestion that overrides were introduced by British insurance companies in the 1970s in response to foreign competition. However these payments quickly became widespread and are also a feature of the US market.

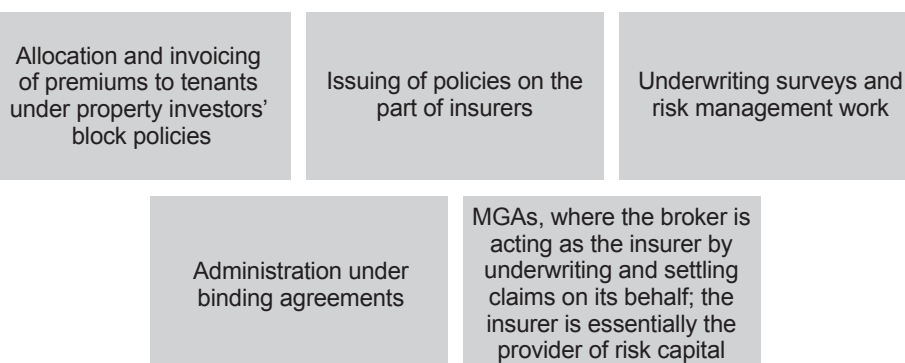
While these payments were not exactly secret, it is also fair to say that they were not widely known either. Also, despite the apparent conflict with brokers' agency duty to their clients, these payments were generally considered to be legal.

Consider this...

Why do you think these payments might be considered inappropriate by clients and regulators?



- **Brokerage applied to otherwise net rated cases:** where the broker is working for a fee, the premium is normally paid net of brokerage. However, for some years the large brokers have also applied a rate of brokerage varying between 1.5% and 5% of the premium. Some brokers describe this amount as compensation for services performed for insurers or more formally called Insurer Services Brokerage (ISB), although insurers are reluctant to agree that they are paying for any services other than distribution.
- **Fees for services to insurers, such as data about client behaviour:** this is a more recent development whereby some of the large broking firms are compiling extensive databases of client buying behaviour which they are able to sell back to insurers. Most insurers now maintain good statistics about the number of quotes they give and their hit rate, but what they don't know is why an insured chooses one insurer over another, thus this data is perceived to be quite valuable – but as ever, the question is 'how valuable?' Of course, brokers have other reasons for compiling such data as it gives them far greater knowledge and control over their account. In effect it can make them real 'distributors' with greater control over where business goes. There is perhaps some irony in this for insurers, since in practice they regard brokers as distribution.
- **Enhanced brokerage,** administration charges and profit commission from facilities or binders operated by the broker.
- **Risk management contributions** paid for by the insurer to benefit clients by improving their risks. Such bursaries may be offered for risk improvements carried out by external companies but, where the broker can offer risk services in-house, it can provide a valuable income stream and help secure the client relationship through enhanced knowledge of the business.
- **Work transfer fees** for certain tasks performed on behalf of the insurer, e.g. premium allocations and tenant invoicing under property owners' policies. Examples of these include:



- **Carrier service agreements:** which are arrangements where the broker actually provides services to the insurer and thus the payments may be subject to VAT. The services can vary from organising meetings between the insurer and the broker to develop the relationship, project work for the development of new products by the insurer, access to lists of clients and the provision of dedicated relationship staff by the broker to assist insurers in their relationship with the broker.
- **Claims preparation costs:** policies will often have cover for payment of claim preparation costs. These cover the cost of preparing the claim, but exclude the cost of negotiation and/or claims advocacy.
- **Premium finance agreement:** brokers arranging premium finance will have arrangements with providers where they will earn a percentage of the interest charge, typically any percentage above the providers base rate.

Brokerage remains the approach for the majority of most, if not all, SME business, supplemented by other payments as described above. However, most commercial accounts where the general insurance premiums are more than £50,000 are now on a fee basis. You are unlikely to find any large accounts that are not on a fee basis.

Insurance Premium Tax (IPT) has increased over the last ten years as follows:

- April 1997 to 30 June 1999 – a standard rate of 4%.
- 1 July 1999 to 3 January 2011 – a standard rate of 5%.
- 4 January 2011 to 31 October 2015 – a standard rate of 6%.
- 1 November 2015 to 30 September 2016 – a standard rate of 9.5%.
- 1 October 2016 to 31 May 2017 – a standard rate of 10%.
- From 1 June 2017 the standard rate is 12%.

The larger increases in the last few years will inevitably dictate whether clients in the mid-large corporate sector choose to work on a fee basis. Many clients in the mid-large corporate sector are likely to be more profitable on a fee basis. The broker fee is not subject to IPT and, given fees are typically around 10% of the premium spend, the extra IPT can make a significant difference.

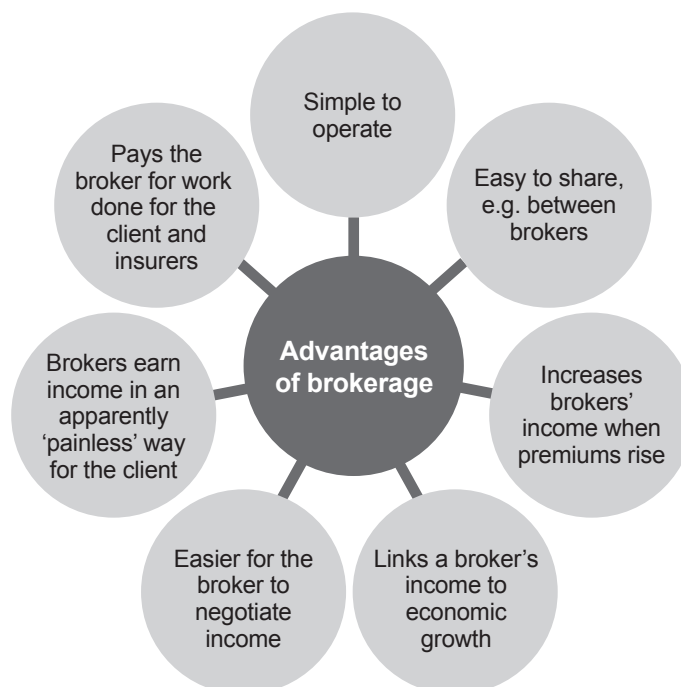
The UK market is probably unique in the extent to which fees have replaced brokerage for commercial business. So if you are studying for this exam outside of the UK, although the arguments are generally applicable, you should be aware of conditions in your country.

One of the early drivers of the change towards fees was the soft property market of the early 1980s. Property premiums plunged often by as much as 50%. This was a time when Britain still had a considerable manufacturing base and as a result, the property insurance premium was often the largest component of a typical client's premium expenditure. The impact on brokers' revenues was profound. Fees offered far more stability.

As brokers started to move towards fees, inevitably competition took over and drove the conversion. The fee basis began spreading through the middle market book in the 1990s and this process accelerated in the new millennium.

The arguments for and against fees and brokerage follow.

A1 Brokerage



That brokerage is simple to operate is self-evident since all modern broking IT systems are designed for this purpose. It is also relatively easy to agree a brokerage split with a wholesaler, for example.

Refer to

Refer to M81, chapters 4 and 8, for more on brokers' services to clients and insurers. You can find these on RevisionMate.

The fact that brokers' income is included within the premium eliminates the need for the broker to negotiate income with the client. If the client chooses not to ask what the level of brokerage is and the broker does not voluntarily disclose it, then brokers' earnings can almost be described as 'pain-free'.

Finally, brokers do work for both their clients and insurers. Brokerage compensates the broker for all aspects of this role.

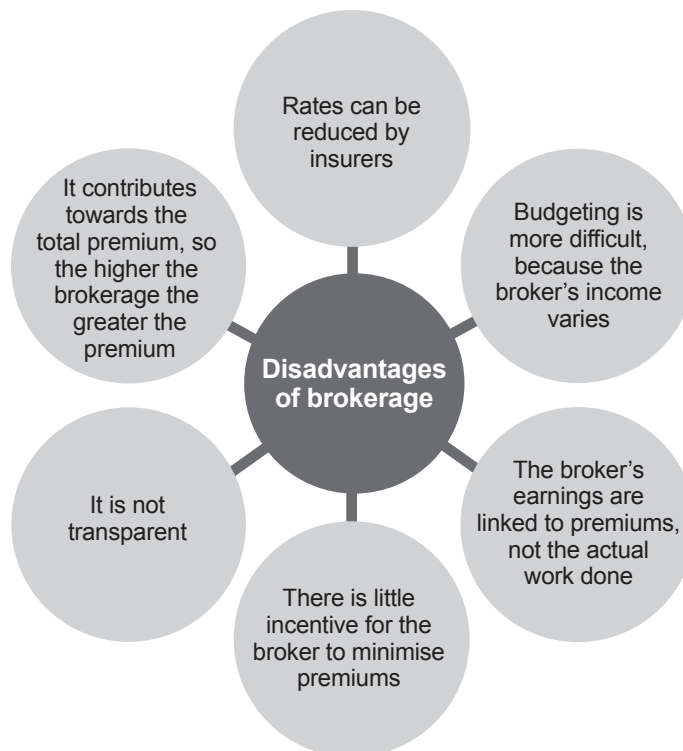
Under the current rules of the **Insurance Mediation Directive 2002/92/EC (IMD)**, commission disclosure is upon request from the policyholder. The review of the IMD initially proposed mandatory disclosure of all broker earnings. However, the **Insurance Distribution Directive 2016/97/EC (IDD)**, which repeals the IMD and was implemented in all Member States on 1 October 2018, has fallen short.

The IDD requires mandatory disclosure of the nature of remuneration received and the basis of that remuneration, i.e. fee, brokerage or benefit-in-kind, although the amount of earnings does not need to be disclosed.

'If brokers have nothing to hide from their customers, then what is the problem with increased and proactive transparency?' asked James Dalton, director of insurance policy at the ABI.

Source: Ugwumadu, J. (2016) 'Industry divided over commission disclosure', *Insurance Age*, 5 July. Available at:

bit.ly/2S0cJ52.



Brokerage rates are broadly set by insurers. There was a time when insurers acted in concert to fix rates of brokerage. However, this practice started to disappear towards the end of the last century, and today would be illegal as a result of the **Competition Act 1998**. The rise of consolidators and networks has weakened insurers' negotiating strength, and rates of commission probably rose to their highest level around 2003. As the soft market continues and insurers' margins come under greater pressure they now have a greater incentive to reduce rates of brokerage.

Since brokerage varies with the premium, it is self-evident that the broker's income will fall as premiums do the same. In chapter 1 you will have seen that periods of softness far outweigh hard markets and thus the broker's income will be depressed over the cycle. Premiums have also been considerably affected by the recession with the resultant impact on brokerage.

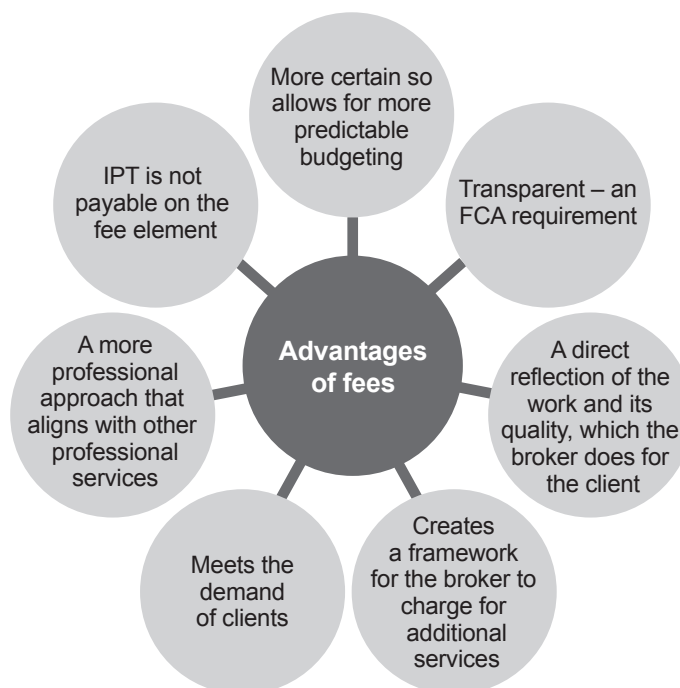
With brokerage, the broker's income is defined by the premium as opposed to the work done for the client, which, of course, has the potential to lead to problems. While it is also true that the brokerage basis gives the broker little incentive to reduce premiums, in the UK the competitive market provides sufficient incentive.

Brokerage is not transparent unless of course a broker chooses to voluntarily disclose it. Clients may request details of earnings to the broker and this tactic is often used by competing brokers in order to discredit the relationship. Brokers are required to disclose the basis of their earnings and any relationships they hold with recommended providers. This information is generally contained in the terms of business agreement and/or 'information pack'.

Brokers (and indeed insurers) occasionally behave as if brokerage does not affect the premium. It is possible for two brokers to get the same gross price from an insurer while different rates of brokerage are paid. In practice this means that the insurer has decided to take a lower margin in order to secure business or a broker may choose to reduce their earnings to secure a piece of business. Insurers are willing to occasionally increase brokerage either on a permanent basis for selected brokers or as part of a short-term campaign to win more business.

A2 Fees

Despite the strength of the arguments both for and against brokerage, fees have grown in significance. Here we consider why.



If one of the problems with brokerage is that it is self-evidently variable with the premium and thus difficult to budget for, then the converse is true. Fees provide far more certainty in budgeting for the simple reason that they are normally fixed for a period – typically twelve months, although three- and five-year contracts are becoming more popular with larger accounts.

By creating a framework that is based on charging for the work actually done by the broker, there is an opportunity for the broker to charge for additional services. However, it is important to remember that some of these tasks will be regarded by the client as part of the broker's role. For example, where a client has a large employers' liability programme, it is impossible for a good broking job to be done without statistical analysis of losses. This type of work should fall within the fee agreement customised to the specific needs of the client.

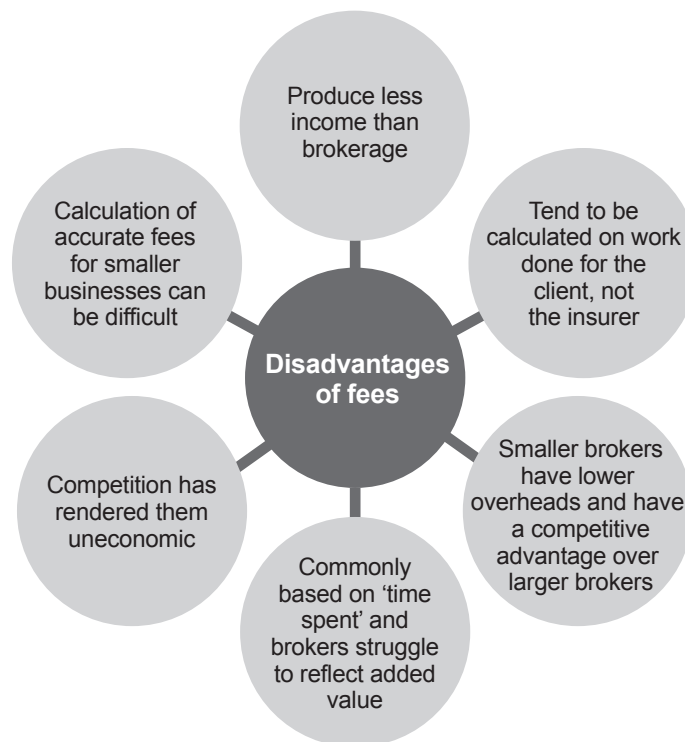
A market-driven argument for fees is that today very few medium-sized and large clients would allow a broker to quote for their service on anything other than a fee basis. Indeed, 100% of today's RFPs (a 'request for proposal', which is an Americanism for a broker tender exercise) specify the fee basis and require complete disclosure of all broker income.

The recent increases in the rate of IPT should encourage more clients to move to a fee-based programme as the fee is not subject to IPT.

Finally, brokers wish to be seen as professionals alongside their peer group in other professions such as accountants, chartered surveyors, lawyers and management consultants. All of these charge fees for services.

Research exercise

Investigate the way other professions charge fees and whether there is the same level of competition between firms that exists in insurance broking.



On average, fees tend to equate to around 8–10% of a premium. This has been the case almost since brokers began quoting fees. If typical rates of brokerage for each class of business are applied, the average rate of brokerage across all premiums would be in the range of 12–14% for mid-sized and larger business.

So the first point is true. When fees first appeared in the 1980s, brokers made the mistake of basing their calculations only on the cost of the work done for clients. Thus no allowance was made for the work done by the broker on behalf of insurers. Primarily, the function that brokers provide for insurers is distribution. Therefore, no matter how efficiently the broker performs for a client, a fee that ignores the cost of distribution is likely to be inadequate.

To an extent, this problem was compensated for by *overrides* and other fees but not to the extent of the loss of income. Therefore brokers began to build an automatic reduction into their revenue budgets that was to be made worse by competition.

Fair reward for added value is a complicated subject. What a broker might consider to be an exceptional value added service, the client might regard as the broker doing their job. Most **fees calculations** are naturally biased towards the time that will be spent and the expenses incurred.

This can be fine for day-to-day service, but makes very little allowance for those occasions when brokers perform a difficult task successfully due to their market knowledge and experience. Often, this will be done in a short time and as a result is inadequately charged for. It might also be argued that brokers are less confident in charging the 'right' fees in comparison with, say, the legal profession.

There is no doubt that for small commercial business and the majority of personal lines business, there is a valid argument that it is impractical to quote fees. A small business might pay a premium of less than £1,000 and simply calculating the fee might make the job in itself uneconomic. Of course, if the broker has a portfolio of businesses, then they can simply

calculate an average fee across the book and ensure that any clients that demand disproportionate time are charged more, put on brokerage or transferred to another, perhaps more forgiving, broker.

This is not currently happening as most of these clients seem happy with the broker's costs being wrapped in the premium in the conventional way.

In any event many brokers do charge additional fees on top of the brokerage for this type of business. For example, a broker might charge an additional 'policy fee' of, say, £25–£40.

It has long been a tradition when dealing with personal lines classes of business that where a client requests a change of vehicle that does not result in an additional premium, the broker charges a small **administration fee** for the work done. While these fees remain modest, they appear not to meet much consumer resistance. It is also worth bearing in mind that for this type of business *overrides* and other supplemental income is still commonplace.

B How fees are calculated

Where fees are charged it is essential for the broker to have accurate methods of:

- recording and analysing the work done for a particular client;
- calculating the costs and expenses incurred, e.g. travel and accommodation, although many brokers, especially on global accounts that require extensive travel, will require these expenses to be paid in addition, on a basis to be agreed with the client;
- understanding all aspects of its own costs; and
- pricing the value to the client of its services.

In practice there are two basic approaches, which are listed in table 12.1.

Table 12.1: Two basic approaches for calculating fees

Simple estimation	Based on the expected amount of time to be spent on the account by each individual. Then applying a multiplier to salaries that includes overheads and the broker's margin.	Probably works best for smaller and medium-sized accounts that do not require a large service team. Not suitable for large and global accounts where the service needs are complex and clients demand formal evidence of the time spent.
Formal time recording systems	Timesheets completed by relevant staff and then entered onto a system; or Data is directly entered into a computer system as the work happens.	Inaccuracies can occur if data is not entered as the work is done or timesheets are not completed. Issue of whose time is recorded. Some firms only record service teams and do not count, e.g. broking as this is treated as an overhead. This is because brokers' time spent per account is much less than the service teams.

The benefits of these systems include:

- the ability to calculate the profitability and resource requirements of each account;
- the correct distribution of the broker's costs thus guiding investment decisions; and
- a comparison of profitability between different departments, divisions and branches.

Inevitably the systems cannot help with the question of value added. However, they do form the basis of a more professional discussion with clients as the rationale for the fee charged. Indeed, some major clients are likely to require the keeping of accurate records of who works on their account, increasing the desire for more sophisticated systems.

One challenge for the large broking firms is consistency of behaviour between different divisions. It is slightly unhelpful for the UK client service function, for example, to introduce a time recording system and build an accurate position of its time spent and costs when this is not mirrored by a sister company that arranges the aviation or marine covers. Another is that some clients have been known to challenge the amount of time spent by senior and therefore more expensive staff, but that is all part of the negotiation.

In some cases, employees feel under pressure to account for all hours spent in the office, which can result in 'time dumping', particularly where the time recording is not completed on a regular basis. Team supervisors and account managers should closely monitor the time recorded by individuals and against each account.

Consider this...

Why are brokers less confident about charging the correct fees and what steps can they take to improve their own position?



C Transparency

In October 2004 the then New York Attorney General (NYAG), Elliot Spitzer, filed a civil lawsuit against Marsh & McLennan; he made very serious allegations, with the threat of criminal action. The allegations concerned the direction (steering) by Marsh of business to insurers who were willing to pay higher rates of commission or contingent commissions. Further, that Marsh used a process of false quotes or 'bid rigging' as it became known, to suggest that the terms obtained were competitive.

It is important to note that in the USA at the time, as in the UK, the payment and receipt of contingents was quite legal.

Marsh's share price dropped as a result of these allegations, a number of senior executives resigned and the US authorities levied a fine in excess of \$850m on Marsh. They also lost clients. Willis, Aon and a number of insurers, while admitting no guilt, also made quite considerable payments, although not on the scale of Marsh.

As a result of the '**Spitzer Affair**', the large brokers in the USA and the UK decided to cease taking volume and profit-related payments, with the exception of the income generated from delegated authorities and facilities. They also decided to adopt voluntary, automatic disclosure of all income received from insurers. However, other brokers in both the UK and the USA continued to accept contingent commissions and very few chose voluntary income disclosure.

The FSA had watched developments in the UK insurance market following the Spitzer Affair and encouraged the market to develop its own solution. However, according to John Tiner (then CEO of the FSA) in his speech to the Insurance Institute of London, 3 October 2006, 'progress on market solutions to introduce greater market transparency has been slow'. Consequently, the FSA announced an independent review of *transparency* and commission disclosure in the wholesale and commercial insurance market.

On the Web

A full transcript of John Tiner's speech to the Insurance Institute of London (IIL), in which he announced the review into transparency, is available to CII members on the CII website:

bit.ly/2qZwZZi.



Table 12.2: A summary of the review process

The objectives of the review were to:	Find out whether there was a lack of transparency in the commercial insurance market that gave risk to substantive customer detriment.
	If so, investigate whether mandating commission disclosure was justified on cost benefit grounds.
The review was carried out by CRA International (CRA) during 2007, and the research was published in December 2007. The key findings were as follows:	CRA found evidence that a lack of transparency in commissions paid to intermediaries in the commercial general insurance market gave rise to market imperfections.
	CRA believe that business customers most at risk are medium-sized firms (between £0.5m and £100m annual turnover). These customers typically buy more complex products that are not available direct from insurers. They also typically pay for mediation services through commission rather than a fee.
	CRA found the lack of spontaneous disclosure meant that many medium-sized customers did not know how much commission they were paying and that, when asked to guess, these customers significantly underestimated the cost. As a consequence CRA believes these medium-sized customers may be paying higher commissions than they should.

Despite the benefits that could be achieved by improving the availability of commission information, CRA believe that a mandatory commission rule would be too costly. They estimated that the direct compliance costs would be £86m in the first year and £34m thereafter, and doubt that the benefits would equal or surpass these costs.

Table 12.2: A summary of the review process

Alongside the publication of CRA's report, the FSA announced a series of measures which included:	Publishing a discussion paper inviting views on the cost-benefit analysis of mandatory disclosure taking into account questions on wider market efficiency, including the potential benefits of standardisation.
	Carrying out thematic work on conflicts of interest to examine the extent and nature of the conflicts of interest arising from the remuneration and contractual arrangements between insurers and brokers and how these are managed.
	An investigation into ways to raise commercial customers' awareness of the value of commission information.

In March 2008 the FSA published a discussion paper: *DP08/2 Transparency, disclosure and conflicts of interest in the commercial insurance market*. In this paper the FSA stated:



Our overarching objective is to achieve a more competitive and efficient market. To deliver this, the outcomes that we are focusing on, subject to the responses we receive to this paper and the results of the additional work we are carrying out, are:

Outcome 1: Commercial customers should have information which indicates the full cost of mediation, including, the likely extent of contingent commissions on a standardised and clear basis and the total amount of commission paid to intermediaries throughout the chain;

Outcome 2: Commercial customers should have clear information about the services an intermediary provides, including the breadth of search he undertakes;

Outcome 3: Commercial customers should have clear information about the capacity in which an intermediary is acting – i.e. whether he is acting for them, for the insurer or, in some cases, for both;

Outcome 4: Conflicts of interest arising from remuneration arrangements/ business models should be properly disclosed and managed;

Outcome 5: Commercial customers should have sufficiently standardised/ comparable information to enable them to gauge the value of intermediary costs and services, and compare these across the market (and over time); and

Outcome 6: Commercial customers should be made aware of their right to commission information and helped to appreciate the value of using it.

Source: Financial Services Authority (2008) *DP08/2 Transparency, disclosure and conflicts of interest in the commercial insurance market*. Available at:

www.fsa.gov.uk/pubs/discussion/dp08_02.pdf.

From 2009, following an agreement struck by BIBA with the FSA, commercial brokers have been obliged to inform clients that they are entitled to ask what commission they are being paid. This should be made clear in the initial pages of their documentation at the outset and at renewal.

In February 2010, after the dust had settled on Spitzer, regulators in New York, Illinois and Connecticut lifted the five-year-old prohibition on contingent commissions for Aon Corp., Marsh & McLennan and Willis Group Holdings in return for greater transparency on agent and broker compensation. This amended the terms of settlement agreements established in 2005. Arthur Gallagher & Co reached a deal with Illinois officials to lift the ban in late 2009. At the time, the chairman of Willis Group Holdings said his firm would not go back to the practice of contingent commissions.

On 21 July 2010 the Wall Street Journal reported: 'Insurance broker Aon Corp said Wednesday it will accept, with some self-imposed restrictions, a form of compensation that for a while was banned after former New York attorney general Eliot Spitzer mounted a campaign against the payments in 2004. Aon joins rival Marsh & McLennan in deciding to accept contingent commissions, after New York's insurance regulator allowed the practice earlier this year.'

On 13 January 2013, the Financial Times reported:

'Opposition is growing against a return to the contentious practice of insurance brokers receiving payments from underwriters that critics complain give the former incentives to avoid pursuing policyholders' claims.'

Alistair Gray, 'Insurers' contingent commissions attacked', *Financial Times*, 13 January 2013



Quoting the outgoing chairman of Willis, a critic of contingent commissions in the past, the industry was 'back to where it was before... the whole industry can now accept contingent compensation as long as you tell clients that you take them – without necessarily enumerating exactly how much that is.' Of his two bigger rivals, he said: 'Marsh does it, Aon does it.'

The article went on to point out, 'People close to rival brokers highlight that Willis itself last year began accepting contingent commissions for employee benefits business in the US. Willis argues it had to do so to remain competitive. It declined to quantify how much it receives from the payments but said it is confined to this particular line of business.'

Aon is reported to have said: 'Our view on transparency and best value for price in the industry is well known. Contingent commissions are not and never have been an important part of our business strategy.' Marsh said on the matter: 'Clients care a great deal about the level of transparency and disclosure around their broker's remuneration, and Marsh believes it leads the industry in these areas. We provide details of how we are paid so that clients can make fully informed insurance-purchasing decisions.' Aon and Marsh also declined to quantify how much they receive from such payments.

So where are we in this seemingly never ending saga? Is the industry 'back to where it was'? In a manner of speaking, yes:

- Insurers are willing to pay contingent commissions (while the ABI calls for full disclosure).
- Brokers of all shapes and sizes are prepared to accept them, along with a variety of other sources of income that (by and large) they are not willing to disclose voluntarily to their clients as to the actual amounts.
- The FCA is as seemingly frustrated as the FSA was that despite all of their efforts (and all of the resources devoted to it) over a period well over a decade, the client population is simply not interested in rising up to exercise its rights (beyond the larger clients whose risk management teams often include ex-industry employees who know well their access rights).
- It remains that mandatory disclosure has not been adopted into regulation.

The review of the IMD seemed to bring forth salvation for the regulators' campaign because for a long time mandatory disclosure of commission was in the plan for the IDD. However, in December 2014, the European Insurance and Occupational Pensions Authority (EIOPA) announced that in a sixth compromise text: 'Commission disclosure: after much debate, the current draft settles on pre-contractual disclosure of the intermediary and the nature, not amount, of their remuneration (whether commission, fee or other type of arrangement)'.

Given that in the same year Parliament rejected the call for mandatory disclosure (accepting the argument that it would be too difficult for customers to interpret all the figures) and Brexit, it does now seem that the matter has been put to bed.

Broking management decision: Disclosure

What are the arguments for brokers not voluntarily disclosing their total earnings? What reasons would you cite for adopting the position for the broker to only be remunerated by fees from its clients, eschewing all insurer and other undisclosed payments?



D Scenario 12.1: Fees v. brokerage

D1 Question

As a result of a determined strategy to grow the business by seeking larger clients, your firm has seen more cases being won by other brokers quoting on a fee basis, whereas your firm has tended to serve its clients on a commission basis.

Consider a proposal for the firm to convert to fees only with the arguments in favour and the information that you would seek.

D2 How to approach your answer

Key points of content

You should aim to include the following key points of content:

- We can make an assumption that this is a smaller firm serving the SME market.
- The firm needs to review its strategy and should conduct a SWOT analysis to identify if the fee issue was the only reason that other brokers were winning the business.
- As part of this, the firm would need to establish what method it would use for calculating fees and how much this would cost.
- It would need to look at its existing clients in the target range to calculate the impact of converting to fees.
- It would need to identify the training that staff might need to deal with the fee basis and methods of documenting the hours worked (electronically or manually by timesheets).
- It would need to review its approach to overrides.
- It would need to bear in mind that it complied with the IDD effective February 2018 and how it communicated to clients the type of remuneration applied.
- The arguments for fees are:
 - they are more certain and therefore allow more predictable budgeting and forecasting;
 - they are transparent and are more likely to meet the transparency aims of the regulator;
 - they directly reflect the work the broker does for the client;
 - they create a framework within which the broker can charge for additional services, such as captive management or contingency planning;
 - demand from clients; more sophisticated clients are used to paying their professional advisers by fee, with the fee reflective of the actual services, and quality, provided; and
 - they reflect a more professional approach which resonates with the desire of insurers and brokers to be seen as a profession by the public, alongside accountants and solicitors.

Self-test questions

1. What are the difficulties in obtaining fair reward for 'added value' under the fee system?
2. Summarise the advantages of fees.

You will find the answers at the back of the book

A black and white photograph of a woman with glasses, wearing a light-colored, textured sweater, sitting at a desk and working on a laptop. She is looking towards the camera with a slight smile. The background is blurred, showing what appears to be a window with a view of trees.

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Quality assurance

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This chapter relates to **syllabus sections 2 and 3**.

Learning objectives

On completion of this chapter and private research, you should be able to:

- explain why quality systems are important;
- describe the key features of insurance broking quality systems; and
- explain the role training and competence play in the prevention of errors and omissions.

Introduction

All businesses must be concerned about the impact of mistakes. For insurance brokers, whose main 'stock in trade' is advice, the consequence of mistakes can be great. We examine the ways they arise and why it is important that they are prevented, alongside the need to adopt effective quality systems.



Key terms

This chapter features explanations of the following terms and concepts:

Errors and omissions	Kaizen	Quality systems	Six Sigma
Technical standards	Training		

A Quality systems



Words of wisdom...

Experience is simply the name we give our mistakes.

Source: Oscar Wilde

Success does not consist in never making mistakes but in never making the same one a second time.

Source: George Bernard Shaw

The adoption of *quality systems* became a management fad that spread throughout Western business in the 1990s and the early part of the new century. It was the result of a popular belief at the time that the Japanese approach to quality, as exemplified by the success of their car industry, was a serious threat to Western industry. Business school research identified the Japanese disciplines of *Kaizen*, or continuous improvement implemented through 'quality circles', as the secrets of success. Quality circles comprise groups of employees drawn from all disciplines and levels of seniority that come together to discuss ways of solving manufacturing problems, improving productivity and achieving the ultimate goal of 100% fault-free output.

This discovery was one of the earliest manifestations of the now global consulting industry. Management consultants sold the idea of Kaizen, quality circles and total quality management (TQM) to Western management looking for ways of improving their businesses and beating the competition. What plagued many of the most high profile projects was a misunderstanding of how the culture of the Japanese workplace, so different to that in the West, was intrinsic to their success. Often whatever system was devised was implemented faster than the business could handle. Many systems took on a life of their own and became too 'external' to the business.

The purpose of a quality system should be to support the business to achieve the highest quality of output in the most efficient manner with the smallest possible number of errors. The systems can have a variety of names including Standard Operating Procedures, Model Office and a number of proprietary names. One of the most famous is *Six Sigma*, a business management strategy originally developed by Motorola, USA in 1981.

In statistical terms, the purpose of Six Sigma is to reduce process variation so that virtually all the products or services provided meet or exceed customer expectations. This is defined as being only 3.4 defects per million occurrences. Although Six Sigma was developed by Motorola in the 1980s it has its roots in Statistical Process Control (SPC), which first appeared in the 1920s. The Six Sigma process is extremely rigorous and its implementation follows the steps of process improvement followed by redesign and then process management.

So one of the key objectives of a quality system is to reduce and eliminate errors. Making mistakes is a fact of life. If this were not true, then insurance need not exist. No business can prosper without taking risks and that means occasionally making mistakes. However, for the

broker, mistakes may lead to a dissatisfied or lost client, or worse, a claim for negligence. In the language of insurance these are known as **errors and omissions (E&O)**.

Of course, quality is not the only feature of a successful business. No matter how well the products are made or professional the service, if no one wants to buy them, bankruptcy looms. But if the basic marketing proposition is right, then quality is a vital ingredient to long-term success.

Many insurance broking firms have implemented quality systems on a voluntary basis, in order to differentiate themselves from competitors and to demonstrate their commitment to quality. These quality systems include ISO 90001, Investors in People (IIP) and more recently Investors in Customers (IIC). While they do not guarantee quality, they do provide a framework that processes could be measured against.

The Chartered Insurance Institute's Aldermanbury Declaration was a positive step towards professional industry standards, adopted by a large number of brokers and insurers. BIBA launched a voluntary code of conduct at their 2015 conference following a strategic review and consultation with members.

We welcome the launch of BIBA's Code of Conduct for insurance intermediaries. The Code echoes our own Principles for Business and will be a useful tool in clarifying both our and BIBA's expectations of insurance intermediaries. Initiatives such as this demonstrate the important role that organisations like BIBA can play in raising industry standards to help ensure good consumer outcomes.

Martin Wheatley, former chief executive of the FCA.

Source: Forsyth, L. (2015) 'On the pathway to raised standards', *The Broker* (BIBA), 4 August, issue 3. Available at:

view.publitas.com/biba/broker-3-2015/page/18-19.



On the Web

The Chartered Quality Institute:

www.thecqi.org.

Deming's principles of total quality management (TQM):

www.well.com/user/vamead/demingdist.html

For more information on Deming's approach, see:

deming.org.



A1 Why quality systems are important

Before we look at some of the features of quality systems, the obvious question should be answered: Why go to all this trouble? From your earlier study of this course and M81, we have seen that clients expect a high level of technical knowledge, business understanding and service from their brokers. Brokers that fail to do this run the risk of losing business, suffering reduced margins from inefficiency and rework, and incurring the cost of mistakes.

There are occasions when clients are lost but the relationship remains sound; another broker may have quoted a lower fee or the client may have decided it was 'time for a change'. In these situations, there remains the possibility of winning the client back. Where poor service is involved, this is less likely to be the case.

Financial	Inefficient work processes increase cost. Errors & omissions (E&O) cost money in their impact on the E&O premium, the cost to the broker of the retained deductible and loss of client revenue. One statistic is that a broker needs to find eight times the cost of an uninsured E&O in revenue to compensate for the loss. Insured claims also affect future premiums.
Reputation and referrals	Referrals are one of the best sources of new business. A dissatisfied client could damage the broker's reputation with other clients and insurers.
Management time and morale	Complaints about poor service and E&O divert management from more profitable endeavour. A serious E&O event can be both debilitating and very time consuming.
Regulatory action	Persistent poor service, the mismanagement of complaints and a consequent E&O could ultimately result in regulatory action.

A2 Features of a quality system for brokers

The following are some of the key features of quality systems.

Table 13.1: Features of a quality system for brokers

Incoming post routines	Specification of who opens the mail, date stamping, etc. In the era of email, this procedure may look ' quaint' but some clients still send letters and certain completed documentation are required in hard copy, rather than electronically.
Incoming email	Mailboxes must be shared so that email for individuals that are absent, including those that have left, can be responded to; there should be a process to ensure that urgent emails are dealt with immediately and the non-urgent are stored for action within a given time. Clients may be encouraged to always copy emails to more than one person.
Outgoing email	Inexperienced or unqualified staff should not be allowed to send critical emails concerning cover, interpretation of policy wordings and other technical matters independently without some form of oversight. Peer review should be used for outgoing correspondence.
Meetings	This covers areas such as the agenda, the use of checklists and the style of notes or minutes.
Broking procedures	Using standardised submissions and agreed policy wordings, ensuring confirmation of discussions promptly.
Appraisal and training	Ensuring all staff have the opportunity for appraisal on a regular basis, identifying and acting upon training needs, setting a method for recording training received, including continuing professional development (CPD).
Management	Ensuring management goals for the business are clear and understood by staff, using appropriate measures to control the business.
Management review	Ensuring that management regularly reviews the effectiveness of the quality system, frequency of errors and omissions, and measures taken to mitigate and prevent recurrence.
Complaints	Ensuring that complaints are recorded, dealt with by an appropriate level of management, where necessary escalated up the line, and that trends are identified; the requirements of the FCA must be implemented. For coverholders with Lloyd's-placed business, complaints may need to be dealt with by the insurers rather than the broker.
Telephone conversations	All telephone conversations with clients and insurers that concern matters directly relevant to an insurance contract and any other important issue relevant to the client should be recorded in detail and preferably confirmed back to the relevant parties in writing within 24 hours. Traditionally, many call centre operations have installed call recording and supervisor listening systems, hence the recorded message we often hear in many industries: 'this call may be recorded for training and monitoring purposes'. This system is now used by general insurance brokers, particularly in personal lines and SME sectors.
Changes in cover, terms and conditions	Change requests from the client to be acted upon immediately or within a specified time and confirmed back to the client.
Diary systems	Effective diary systems are essential to alert the broker that a renewal is due; that tasks passed to another party; for example, a request for an extension of cover, are acted upon in good time; to ensure that premiums are collected from clients and paid to the market within agreed timescales; to ensure that any warranties applied to the contract are handled prior to their requirement date.
Self-assessment file review	A check carried out by the main originator or a given process, such as a renewal, that all the steps in the process that are specified in the quality system or standard operating procedure have been carried out.

Table 13.1: Features of a quality system for brokers

Supervision/peer review	The 'second pair of eyes' (SPOE) check. This means that someone who is not involved in the origination of the work checks it. It is often much more difficult for the person who has been heavily involved in a task to spot errors, or even see if there is anything wrong, because they are too close to the work. Of course, this is not foolproof as two people could miss the same error. It is also only effective when there are robust procedures to ensure quality before the SPOE and where the staff carrying out the SPOE have the time and experience to do it effectively. Such a review should be checking for quality and if the reviewer does not have the professional knowledge and expertise to evaluate the advice or statements given, then this approach will default to checking a process, i.e. that the letter went out at the correct time and not that its contents were correct. The SPOE system can also be compromised if fundamental information is incorrect, e.g. a policy register page or an underwriting submission will contain sums insured and other factual statements about the risk. Except in the event of a detailed audit, it is not practical for the reviewer of a piece of work to check this information. However, spot checks are a valuable addition to this method of checking. This method of supervision clearly works best in an environment where people can admit mistakes and where senior staff regard the coaching of more inexperienced staff to be a vital part of their job.
Filing systems	It is important to recognise how effective an orderly filing system can be. Many errors occur because documentation is not filed chronologically, is missing, is distributed in a haphazard manner or there is no system for controlling the movement of files. The advent of email has compounded filing problems. 'The File' must be complete so that, where a paper-based filing system is used, hard copies of all emails and attachments must be printed out and attached to the paper file. The most effective procedure is for each file concerned with the transaction of business to have some form of activity record/control sheet. This log should record all of the activity on the file. Law firms attach a great deal of importance to this practice and junior staff are indoctrinated in the procedure. The benefit of this approach is that anyone picking up the file can see what has gone on in the past and what stage negotiations have reached. This avoids the classic source of errors where a person, unfamiliar with the file and acting on a piece of new correspondence, only examines the last few pieces of correspondence and misunderstands the action to be taken. The danger here is that as each unfamiliar person handles the file, errors multiply. It is this scenario that leads to the sort of complaints that appear in newspapers, whereby a hapless member of the public simultaneously receives new policy documents confirming receipt of premium and letters threatening cancellation of the policy because of non-payment. The clear benefit of this procedure is that it is extremely effective but costs very little to implement.
Email/paperless offices	Email is now an essential business tool. There are concerns over the security of attachments that can be altered or corrupted, proof of receipt and the fact that emails can, of course, be sent anywhere in the world. Most businesses judge that the benefits outweigh these risks. The prime benefits of email include low cost, speed, the ability to transmit huge volumes of data instantaneously and, despite some UK legal concerns, the ability to record transactions instantly.

From a quality system perspective the issues with emails are:

Problems with emails	• Uncontrolled filing – individuals using personal folders. • Uncontrolled deletion of emails. • Uncontrolled export of files and data to external email addresses. • Emails responded to/prepared by inexperienced staff and issued without review.
How brokers deal with them	• A standard filing hierarchy in 'public' folders with multiple access. • Clear rules concerning responses and their supervision. • Maintenance and regular review of an electronic version of the paper activity and transaction record sheet. • Alternative back-up storage source and recovery system. • Maintenance and regular review of an outstanding items list. • Clear protocols about the use of language in emails – responses should be polite and business like, despite the 'informal' feel of email.

Paperless offices are now becoming the standard as email is the dominant form of business communication and the cost of the technology, particularly electronic storage, has fallen. While most documents will be kept in electronic form, there are still some that need to be

scanned and stored, for example London Market slips stamped by underwriters, or signed proposal and other application forms. The conventions for naming and holding these documents need to be clear and to form part of the filing hierarchy described above.

A3 Audits and quality systems

Where the broker is working to acknowledged quality systems such as ISO 9000/1, a system of audit is a condition of the accreditation. These need to be distinguished from internal audit of financial accounts which are necessary to support internal management accounts.

The audits can be performed internally, provided a clear degree of independence on the part of the internal auditor can be demonstrated to the external accreditation body. Alternatively, an external verification body can perform all audits, but this is a much more expensive approach and tends not to be favoured by larger firms.

In the absence of a quality accreditation, some form of internal audit is essential. For smaller brokers where the cost of an internal audit team would be prohibitive it is possible to commission external audits from professional auditors. However, the most practical approach is a system of spot checks carried out by management.

The quality audit will be conducted against the standards that the firm has set. These will comprise the features described above. So for example, if there is a standard procedure concerning SPOEs, the audit will check whether that is being complied with.

Clearly there must be a direct connection between such audits and those conducted as part of the regulatory compliance system.

The true value of auditing is to analyse the findings in order learn from mistakes by improving systems or staff training. However, many organisations fail to communicate the lessons learned through management to the front line operators.

B Errors and omissions

One of the key objectives of a quality system is to reduce and eliminate errors. Making mistakes is a fact of life. If this were not true, then insurance need not exist. No business can prosper without taking risks and that means occasionally making mistakes. However, for the broker, mistakes may lead to a dissatisfied or lost client, or worse, a claim for negligence. In the language of insurance these are known as **errors and omissions (E&O)**.

B1 What causes mistakes?

It could be argued that each E&O incident has its own unique features. But like mistakes in any other walk of life there are probably some common themes.

Mergers, acquisitions and consolidation: The integration process inevitably leads to indigestion, disruption, redundancies and lack of focus on clients.

Technical training and education: In *Error prevention and technical standards* on page 13/10 we consider the suggestion that technical standards have fallen over the past 25 years.

Reduced standards of supervision: People that entered the insurance profession 20 or 30 years ago will have experienced a relatively high degree of supervision, particularly for staff with less experience. For example, outgoing post would often be counter-signed by a team leader. Junior underwriters would have had to refer underwriting decisions to senior staff, and so on. Today, we seem more diffident about the exercise of authority in this way. The explosion of email has also made the task of supervising communications between broker and underwriter, and broker and client much more difficult.

Policies: Before the advent of contract certainty at inception (CCI), the insurance profession had become remarkably sloppy with respect to its key product, namely the policy document. Error rates tended to be high and policies were often issued months if not years after inception. The problem was particularly acute in the London Market and major UK risks where negotiations over cover dragged on interminably. Fault lay with both insurers and brokers. This has been partly but not completely resolved by the CCI initiative.

John Tiner raised the stakes in a debate that has been ongoing in the London Market for years when he stated:

The lack of contract certainty creates risks for the policyholder as well as the insurer and the brokers. For underwriters there is substantial operational risk related to pricing and documentation errors and delays that create uncertainty. Also the insurer has an incomplete knowledge of the risk it has underwritten and the share of any risks taken by each insurer. For the brokers there are large and unquantifiable legal risks.... And last but not least, the insureds do not know exactly what protection they have bought.

Source: John Tiner, former chief executive of the FSA, New York, 13 December 2004.



Impact of the market cycle: Soft markets mean more than just lower premiums. They tend to reduce standards overall. More difficult risks can be placed with less information and without much skill on the part of the broker. Underwriters are less rigid on policy conditions, at least at the underwriting stage, and less time is spent on the detail. Despite knowledge of these market conditions, the management of brokers and insurers still seek growth and increased market share.

Economic pressures: Some of the worst problems have probably arisen as a result of a desire for short-term profits. With the benefit of 20/20 hindsight, the pensions mis-selling scandal and the film finance shambles look completely avoidable. The total cost of these two episodes is simply vast in comparison with the money actually made by both brokers and underwriters. The same might be said of payment protection insurance (PPI), mainly sold by banks.

B2 Examples of errors and omissions

The examples given below are based upon real life, although they have been subtly altered, and serve to illustrate the problems that do occur.

Table 13.2: Examples of errors and omissions

Error or omission	The context	The problem	The outcome
Documentation failures	A business interruption policy has had its indemnity period increased from 12 to 24 months. The change has not been clearly recorded on the file and the revised policy document has not been issued. The letter confirming cover is buried in the middle of the file, as there has been subsequent correspondence on an unrelated subject.	At the next renewal, the client submits an estimate of gross profit based on 12 months. The account broker sends this to the insurer and omits to adjust this amount to reflect the 24-month indemnity period. After renewal, a loss occurs resulting in 15 months' interruption.	The appointed adjuster quickly establishes that there is underinsurance as the sum insured is based upon the 12-month number and not 24. The insurer continues to deal with the loss but on the basis of making a reduced settlement.
Disclosure of all material information	A London broker is placing public liability cover for a foreign power utility based in a country where bushfires are common. The initial information submitted by the producing broker includes reference to a fire caused by electric arcing that occurred six years ago. Apparently this is a relatively common problem but no mention is made of this fact.	In preparing the submission for the market in London, the London broker decides to delete reference to the fire loss on the grounds that market convention is to present five years' claims and that a claim in the sixth year back is irrelevant.	The risk is bound and three months later, arcing causes a substantial fire. Insurers decline the claim on the grounds of non-disclosure of material information.

Table 13.2: Examples of errors and omissions

Appreciation of the extent of cover	ABC Insurance's commercial package wording includes theft but has the following exclusion: 'Damage caused by theft not involving forcible and violent entry or exit to the buildings of the premises.' XYZ Broker plc places a university with ABC. A few years later thieves enter the premises at around 8:00 p.m., a time when access to the premises is not controlled. The thieves enter a computer room using a stolen swipe card. They steal equipment but in doing so set off an alarm. They force a rear fire exit door to the computer room but are able to escape from the building through an unlocked door.	The claim is declined by the insurer on the grounds that there was no forcible and violent entry or exit to the 'buildings of the premises'.	The insurer points out that, had it been asked, it would have quoted for 'full theft' cover and had recently done so for other branches of the broker for similar risks.
Responsibility to explain terms fully to the insured	A broker obtains a quotation for a roofing contractor. The quote is provided by phone and confirmed by fax and is made subject to the insurer's 'usual heat conditions' which are not specified. Before the policy is issued, the broker issues a register of insurances which describes the cover as being subject to the 'insurer's standard application of heat warranty'.	Within the course of a job extensive damage is caused to the roof of a building as a result of the tar pot catching fire. During the investigation, the insurer points out that its standard 'heat conditions' say that tar pots must not be taken onto the roof where the work is being done.	On learning this, the contractor says that had they known this they would never have accepted the quote as it would have been impractical for the condition to be complied with.
Lack of appreciation of potential consequences for the insured	All risks cover is arranged on a chain of DIY superstores, subject to an excess expressed as '£25,000 each and every claim'. A hurricane moves over the country starting one afternoon and ending early the next morning, affecting nine of the stores. The appointed adjuster authorises repairs but points out to the insured that the excess will be applied to each site.	The insured complains that the excess should only be applied once, as the cause of each loss was identical and related to one cause. The insurer responds by saying that, had it been asked to quote on the basis of the excess applying to each and every claim or series of claims arising from 'the same original cause', it would have done so. It would also have quoted if asked for a 72-hour clause.	However, it would have required a higher excess of £150,000 and charged a premium about 15% higher. Eventually a compromise is reached but the client is left distinctly unhappy.

Table 13.2: Examples of errors and omissions

Failure of supervision and management	At 3.30pm a client telephones to confirm that a quotation to extend a public liability policy to include financial loss has been accepted and it is agreed that cover will be bound straight away.	The account broker has made a scruffy note that only makes sense to them. Before calling the insurer, the broker is called into an urgent meeting. By the time the meeting finishes, it is after business hours so they decide to leave it until the next day. Unfortunately that night the broker contracts serious food poisoning and is off sick for two weeks.	His colleagues fail to notice his scruffy note and cover is not bound.
Pensions mis-selling	Although most E&O claims relate to individual brokers and specific circumstances, a number have arisen that share a common theme and affect more than one broker. The pensions mis-selling scandal of the late 80s and early 90s affected large numbers of independent financial advisers, many of whom were connected to insurance brokers.	The scale of the problem was far beyond what E&O underwriters anticipated, with many firms receiving claims in excess of their policy limits.	The total compensation bill for the financial services industry ran to billions of pounds.
Film finance	The basic theory was that, although it was difficult if not impossible to predict the success of an individual film, by packaging groups of films and setting the right excess points, an insurance contract could be put together that would 'guarantee' the return on the package. Thus the 'underwritten' package could then be financed by a bank that took little of the risk.	You may recognise the similarity with the sub-prime crisis, whereby groups of mortgages of dubious quality could be magically mixed with 'high' quality mortgages to produce an AAA investment instrument. Naturally, the outcome was the same.	Film finance exploded in the early to mid-nineties involving a large number of brokers. The result was a blizzard of litigation and E&O claims at great cost to insurers, brokers and their E&O insurers.

Brokers' duties are far reaching and E&O claims represent a significant cost to any broker. Although professional indemnity (PI) insurance is in place (a requirement of FCA regulation), any claims will increase future premiums and most PI policies carry a sizeable deductible. Many E&O claims arise from the duty of disclosure, where legislation has recently changed in the following areas:

- **Consumer Insurance (Disclosure and Representations) Act 2012**, which came into effect in the UK on 6 April 2013. Consumers (individuals arranging insurance wholly or mainly for purposes outside their trade, profession or business) must only 'take reasonable care not to make a misrepresentation'. This reduces the burden on the proposer to disclose all material facts and presents a challenge to insurers and brokers to ensure they ask specific questions to gather all relevant information. Price comparison websites have an additional challenge to ensure they cover the range of specific questions posed by all participating insurers.
- **Insurance Act 2015**, which came into effect in August 2016. While the Act removed 'basis of the contract' clauses, it increased the duty of brokers in advising clients and presenting the risk to underwriters by replacing the duty of disclosure with the duty of fair presentation.

On the Web

You can find further details on the Law Commission's website: bit.ly/2Qet1Ks.





Research exercise

The 2010 legal case *Environcom Ltd v. Miles Smith (2010)* indicated an increase in duty on the part of the broker. Not only must a client be warned of the duty to disclose material facts, but the broker also has to establish that the client has fully understood both the duty and the consequences of failure.

Find out as much information as you can about this case, and be able to explain the principles developed by the judge.

See also:

- *Café de Lecq Limited v. R A Rossborough (Insurance Brokers) Limited (2012)* to research the broker's duty to warn about onerous warranties on policies sold through a website.
- *Eurokey Recycling Limited v. Giles Insurance Brokers Limited (2014)* highlights the importance for brokers to document advice given (this case relates to the adequacy of sums insured on a business interruption policy).
- In the case of *Pakeezah Meat Supplies v. Total Insurance Solutions (2018)* the broker was found at fault. They had neglected to inform the client of the disclosure obligations, did not ask the right questions in order to assess the appropriate level of cover and (as a result) failed to provide adequate advice.

C Error prevention and technical standards

The majority of staff will never be involved in even a minor errors and omissions incident. In fact, many staff may find procedures for the disclosure of incidents that may lead to claims tedious and unnecessary. Many mistakes may never come to light or are discovered quickly enough to be put right without further problem. To ensure that staff do not therefore become too complacent about mistakes it is essential that they understand how mistakes occur, the basic techniques to control and prevent errors and understand the nature of systems and the consequences of non-compliance.

C1 Training

Table 13.3 outlines a training session that companies may implement to help employees' understanding of E&O incidents and how to prevent and minimise the effect of such an incident.

Table 13.3: A training session in understanding E&O

Stage 1	A review of typical claims incidents.
	Brainstorming sessions where team members hypothesise various forms of mistake.
	Real-life experiences as faced by trainees.
	Brainstorming the possible consequences of mistakes, such as the cost and impact on reputation.
	Reviewing complaint outcomes irrelevant of result and implementing changes from feedback if relevant to quality assurance.
Stage 2	Looking at the office systems developed including an overview of the systems and their application within the broker's office.
	An explanation of the main features of the systems in relation to examples of mistakes.
	Testing for understanding.
	What constitutes an incident? When it should be reported and what steps should be taken to eliminate the problem – this will include a clear explanation of the system of accountability within the broker's office.
Stage 3	What the member of staff should do if they feel that the incident disclosed has not been responded to correctly – the immediate action that should be taken.
	Giving staff confidence that immediate disclosure of a problem will not result in disciplinary action.

Broking management decision: Prevention rather than cure

Why is it important to implement quality systems and systems to prevent errors and omissions?

**C2 Technical standards**

Technical standards should form part of the quality system as a key feature of overall service offering. Clients expect a good standard of technical capability in the people they deal with and a broad level of technical knowledge of insurance. After all, this is one of the key reasons for selecting a broker.

The challenge for firms, large and small, is how they ensure that both individuals and the firm overall have the necessary skills and knowledge. A view widely expressed in the profession from both insurers and brokers is that technical standards and skills have fallen over the past 25 years. Supporting this data with hard facts is difficult, but the usual reasons given are listed in table 13.4.

Table 13.4: Reasons for the fall in technical standards and skills

Movement	of personal lines and 'small' business to highly automated call centre environments where less technical knowledge and skill are required.
Pressure	on margins for both insurers and brokers from long periods of soft markets.
Quality	of people entering the profession as it becomes less attractive in comparison with other jobs, e.g. investment banking and IT.
Lack	of regulatory and industry-wide pressure for professional qualifications.

Some support of this view is given by the current drive within the profession to raise standards. This is being led by the CII through the Aldermanbury Declaration. While these views may be true of the profession overall, there are many brokers, large and small, who achieve differentiation by maintaining high levels of technical knowledge and encouraging staff to become qualified and to learn continuously.

Against this background technical standards can be managed in the following ways:

Qualifications: supporting and incentivising staff to achieve the relevant qualifications such as the ACII, especially through the attainment of Chartered Broker status.

Standards and assessment: implementing skills matrices, assessing technical capability at the time of interview and maintaining knowledge of employees' competence through regular assessment throughout their career.

Technical guides and standard documents: producing technical insurance guides and setting high standards for the quality of information gathering from clients and underwriting submissions to the market; for smaller firms that do not have the depth of technical resources, there is a variety of external help including that offered by the trade associations and broker networks and subscription-based online technical resources.

Agreed wordings: many brokers require insurer standard policy forms amended to meet their specific requirements; one clear advantage is that if the broker has a series of agreed wordings with its principal insurers, error rates in policy production should be reduced or eliminated.

Broking management decision: Technical competence

What are the benefits of achieving a high standard of technical competence?



D Scenario 13.1: Quality training

D1 Question

A new member of staff tells you the procedures the firm uses are inefficient and bureaucratic and they do not see why they cannot send emails to clients and insurers without them first being checked and then saved into a common folder with a copy to her line manager. They say other more experienced members of staff feel this way.

Prepare a presentation that can be used for staff briefings and training that addresses the key issues.

D2 How to approach your question

Key points of content

You should aim to include the following key points of content:

The question suggests that the firm needs to review its training in the quality system and the prevention of E&Os.

It also suggests that perhaps the procedures should be reviewed even if there are good reasons for their 'bureaucratic' nature.

The impact of mistakes should be emphasised.

- Loss of clients.
- Reputation and loss of potential for referrals.
- Cost, especially if an E&O is self-insured or within the policy excess.
- Management time.
- Possibility of regulatory action.
- Impact on staff morale, particularly for the affected staff.

Training should look at:

- Why the system is in place.
- Examples of claims.
- Real life experiences.
- Quality of understanding.
- Nature of incidents and what should be reported.
- Creating a culture where mistakes can be admitted.

Self-test questions

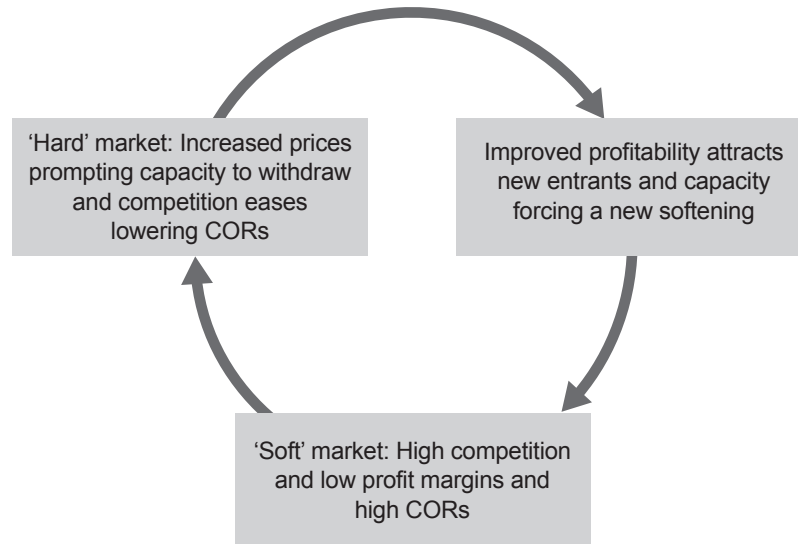
1. Explain a 'second pair of eyes' (SPOE) check.
2. Briefly describe some of the issues that can arise with emails.

You will find the answers at the back of the book

Chapter 1

self-test answers

1 Your diagram should look like this:



- Losses begin to exceed the investment returns.
- Losses become unsustainable as they exceed earnings.
- Capital reduces.
- Insurers either stop writing particularly loss-making business or drive rates up (known as the hard phase).
- Increased rates lead to increased profits.
- More capital is then attracted back to the market and the resulting increased competition leads to a soft market, and so the cycle continues.

2 Brokers are primarily the agents of their clients and must put their interests first.

Two from:

- understand the client's business, its risk and insurance needs;
- design and source the most appropriate insurance cover, explain the options and give reasons for the advice;
- negotiate cost, cover and other terms that meet the client's needs;
- execute the client's instructions in an efficient manner;
- explain the needs and the behaviour of the market to clients;
- maintain effective relationships with the market in order to achieve the best results for the client;
- negotiate claims;
- administer all aspects of the transaction in an efficient manner and maintaining the necessary records.

Brokers also act as a channel of distribution for insurers and in performing that role they may face conflicts of interest that they have to manage carefully.

Two from:

- understand the risk appetite of an insurer.
- present risks in an efficient fashion so as to obtain the right terms quickly.
- build relationships with insurer personnel so as to ensure the right terms for the broker's clients.
- place sufficient premium with an insurer to meet its minimum requirements.
- act for insurers and other capital providers where the broker has delegated authority to underwrite risks or settle claims.

Chapter 2

self-test answers

- 1 Distribution cost is all those costs that an insurer incurs in moving the product or service from the point of origination to the end users. So these will include commission/brokerage and other incentives paid to intermediaries, the branch network and staff needed to support each distribution channel, advertising, relationship management, sales and customer service, IT and marketing costs.
- 2 This is how the offered services and products respond to the client needs and wants. The client has a problem and the proposition is the solution. The proposition is therefore defined, e.g. in terms of:
 - the demographics of the client marketplace;
 - the location of clients;
 - the specific needs and wants that reflect their individual characteristics;
 - how the products and services offered respond to these needs and wants or how they need to be adapted or tailored to do so;
 - how it will be delivered and where from; and
 - the cost of providing the proposition.
- 3
 - The economics of 'ex-growth' sectors can be improved by using consolidation to gain scale and efficiency.
 - The resulting consolidated businesses attract more investment.
 - Opportunities to replace complacent management.
 - To secure better deals from suppliers.
 - To provide a stronger base for expansion.
 - Provides a substitute for organic growth.

Chapter 3

self-test answers

- 1 If an insurance intermediary informs a customer that it gives advice on the basis of a fair analysis, it must give that advice on the basis of an analysis of a sufficiently large number of contracts of insurance available on the market to enable it to make a recommendation, in accordance with professional criteria, regarding which contract of insurance would be adequate to meet the customer's needs.
- 2
 - Insurer limits on the number of brokers they will deal with.
 - The number of available insurers exceeds the economic maximum for even large brokers.
 - It produces cover and pricing benefits for clients and efficiency and income benefits for the broker.
 - Many brokers use single-insurer facilities.
 - It can be more cost effective to deal with fewer insurers for certain types of business.
 - Concentration and aggregation of business with fewer insurers may give the broker greater influence and the ability to negotiate generally better terms overall for clients.
- 3
 - Join one of the networks described in chapter 2.
 - Seek out MGAs that cater for the needs of the smaller broker.
 - Form a purchasing group with other similar-sized brokers.
 - Targeting one or two insurers where the broker is suffering from poor service by getting to the right relationship management people and demonstrating the value of the broker's account and why it is a growing business that insurers should be dealing with.
 - Use one or more of the many specialist wholesalers.
- 4
 - A good relationship helps to ensure that the broker's risks are dealt with first.
 - It may assist with negotiations on difficult claims.
 - Many insurers may be willing to work with and even fund (subject of course to necessary disclosure) brokers for marketing projects and campaigns.
 - Insurers can be a useful source of general market-based information.
 - Insurers also conduct sector-based research that they will be willing to share with supporting brokers.
- 5
 - Maximum efficiency requires significant investment and cooperation between the parties.
 - Cost of investment.
 - Security.
 - Filing and control of email messages.
 - Permanence of electronic messages changes the litigation risk.
 - Susceptibility to attacks by virus, criminals and terrorists.
 - The internet is 'free' mentality.
 - Legal uncertainty.
 - Regulatory issues.
 - Clients not moving as fast as insurers in adopting technology.

Chapter 4

self-test answers

- 1
 - Systems – either spreadsheets but more often dedicated software to collate and manage prospects; these systems can be local or global and some are integrated into customer relationship systems. System choice is a function of the size and needs of the firm.
 - Status – all purpose-designed systems include a ranking system that categorises each prospect by the closeness of the relationship, ranging from no contact having been made through to regular and friendly dialogue; some firms use as many as seven categories, however, four, 'cold, warm, hot and reporting' work for most.
 - Alignment with broker skills – each prospect should be assessed against the skills and resources of the broker to ensure that the broker has a good 'fit', thereby increasing the chances of success.
 - Sectors – prospects should be classified by their trade segments – this facilitates campaigns described below.
 - Reporting weighting – once a prospect has moved to the stage where the firm has been invited to review, it is appropriate to weight the chances of success so that the system can generate management data about the value of the pipeline.
 - Outcome analysis – so as to improve future performance, it is good practice to analyse why accounts are won and not won.
- 2
 - Campaigns: the broker nominates a day when all staff are involved in a cold calling campaign and a competitive atmosphere is created with league tables; these require a degree of planning and lists of contact names and numbers of prospects that have been 'cleansed' so that the data is accurate; these campaigns are also useful to identify staff that have a flair for selling and dealing with difficult situations.
 - Individuals: all sales and client service staff are set targets to make a given number of cold calls in a given period; these targets can form part of the incentivisation for the individuals; the problem with this approach is disinclination by staff to engage in cold calling.
 - Dedicated functions: dedicated staff with the training and skills to make calls can be deployed; some firms centralise this function which then supplies leads to sales and client service staff.
 - Contractors: some brokers employ specialist companies or lead generators to make the first contact for a finder's fee. This may be per successful call, appointment made or even a share.
- 3 The use of proprietary sales tools to assist businesses in selling to prospects. They:
 - identify the best opportunities, those where there is a greater chance of winning. The objective is to enable scarce resources to be allocated where they will yield the best returns;
 - bring structure to the process of understanding how to match the needs and personality of the client with the skills and resources of the broker;
 - identifying the individuals at the prospect and how they will influence the outcome of the review. Terms are used such as economic buyer – the person who will most influence the buyer, the coach – the person who may not have the final decision but who will help the broker win the business.
- 4
 - The whole bonus structure should be transparent to all.
 - There should be a fair division of rewards.
 - Truly exceptional performance should receive exceptional rewards.
 - Everyone should remember that bonuses can go down as well as up.
 - There should be a link to overall performance whether within the specific division or the firm as a whole and this link should be the larger component, the more senior the person.

Chapter 5

self-test answers

- 1
 - To encourage the directors and senior managers of firms to take appropriate practical responsibility for their firms' arrangements on matters that are likely to be of interest to the FCA because they impinge on the FCA's functions under the Financial Services and Markets Act 2000.
 - To increase certainty by amplifying Principle 3, under which a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
 - To encourage firms to delegate responsibility for effective and responsible organisation in specific directors and senior managers.
 - To create a common platform of organisational systems and controls requirements for all firms.

- 2 The FCA will have regard to a number of factors when assessing the fitness and propriety of a person to perform a particular controlled function. These are set out in the FIT module of the FCA Handbook. The most important considerations will be the person's:

- honesty, integrity and reputation;
- competency and capability; and
- financial soundness.

In assessing fitness and propriety, the FCA will also take account of the activities of the firm for which the controlled function is to be performed, the permission held by that firm and the markets within which it operates.

The FCA will not usually require the candidate to supply a statement of assets or liabilities. The fact that a person may be of limited financial means will not, in itself, affect their suitability to perform a controlled function.

- 3 There are three pillars to the FCA's supervision model:
 - The Firm Systematic Framework (FSF) designed to assess the firms conduct risk, asking the question 'are the interests of customers and market integrity at the heart of how the firm is run?'. This entails business model and strategy analysis, embedding of TCF including governance and culture, product design, sales and transaction process, and post-sales services.
 - Event-driven work: supervisory activity in response to issues that are emerging or have recently happened. This is the flexible element of how the FCA will allocate its supervisory staff so that resources are devoted to situations and firms of heightened risk to consumers. For example, whistle blowing alleged misconduct or a spike in reported complaints.
 - Issues and products: the flexible approach will also allow the FCA to look at reviews of issues and products as they take place.
- 4
 - Did they exercise reasonable care when considering the information available to them?
 - Did they reach a reasonable conclusion and act on it?
 - What is the nature, scale and complexity of the firm's business?
 - What is the person's role and responsibility as an approved person performing a significant influence function?
 - What regulatory concerns, if any, have arisen in the business under their control?

Chapter 6

self-test answers

1 Select from:

- The size and nature of the compliance function expected by the FCA will reflect the broker's size and resources.
- Procedures must be adequate to detect the risk of the failure of the firm to comply with the regulation and other business risks.
- Procedures must be adequate to minimise the risk of the failure of the firm to comply with the regulation and to allow the FCA to exercise its powers. These should also reflect the scale and complexity of the firms and should be designed to ensure that the firm is complying with its obligations such as fair market analysis, treating the customer fairly, disclosure and so on. They should be capable of internal and external audit.
- A broker's own compliance function must be allowed to operate independently and must be responsible for the adequacy of compliance procedures, monitoring of compliance, action where necessary and ensuring that people undertaking regulated activities can meet the necessary obligations.
- The compliance function must have the necessary authority and expertise, access to relevant information and be staffed by people independent of the daily business of the firm.
- Remuneration must not compromise the objectivity of the functions employees.
- The function should have independent reporting lines to a senior executive who is not responsible for day to day business unit management.
- Compliance must be separated from internal audit.

2

- Ensuring full compliance with the regulations.
- Indemnifying liabilities that arise from the activities of the appointed representative.
- Keeping the FCA notified of who their appointed representatives are.
- Reporting to the FCA on appointed representative activities.

3

When a company provides leaflets to promote regulated business products. It does not recommend or provide any regulated advice.

4

An Unregulated Introducer Agreement.

5

Select four from:

- Management information that enables management to assess, monitor and mitigate bribery and corruption risks with particular reference to higher risk third party payments, the control of introducer accounts, bank accounts and the like.
- Bribery and corruption risks must be evaluated as part of the firms overall risk management.
- Clear and documented responsibility for the function of monitoring and managing the bribery and corruption risk and ensuring this was understood by all relevant members of management.
- Additional vigilance in all dealing with 'high risk' countries using appropriate monitoring techniques.
- Rapid action upon the discovery of an incident that may indicate and increased or actual risk.
- Regular review of all business practice as it may affect the management of the bribery and corruption risk.
- Clarity within the firm over the definition of a third party. It suggests as a starting point that firms should regard all companies and/or individuals involved in

insurance transactions who are not the underwriter or the insured to be third parties.

- Effective identification of 'high risk' third parties, for example those where there is an inadequate business case for the payment of commission.
- Documenting the reasons for all payments to third parties.
- Identifying connections between third parties and the insured or public officials.
- Applying appropriate procedures when acquiring other firms with arrangements with third parties.
- Identifying and documenting reasonable levels of commission.
- Robust procedures to confirm third party bank details.
- Appropriate and robust controls around payments.
- Robust recruitment procedures.
- Regular and effective training.
- Monitoring of the risks from remuneration.
- Effective suspicious activity reporting and whistle-blowing procedures.

6 Devising and implementing a competition compliance policy specifically tailored to the needs of the broking firm.

Implementing a training and education programme for all staff, with a particular emphasis on senior and operational management.

Devising specific protocols for the placement of co(re)insurance business that:

- takes into account the needs of the client;
- considers the merits of co(re)insurance agreements placed on the same terms, known as 'horizontal' placements and those split with different terms, often known as vertical placements;
- describes how the competition for leading underwriters is to be conducted;
- considers the cost of the two methods of placement; and
- reflects the specific training needs of staff.

Chapter 7

self-test answers

- 1 Executive directors work full time in the company and are given management responsibility for running parts of the business. The board usually appoints one of the executive directors to be accountable for the running of the company on a day-to-day basis. This person is variously known as the chief executive officer (CEO) or managing director. The CEO in turn appoints the company management.

Non-executive directors are part-time appointments selected for the expertise they bring to the board. They do not perform an executive management role in the company. However, they attend board meetings and may be members of sub-committees in order to provide an independent view on matters such as audit, management remuneration and risk management.

- 2 Business risks are all those risks that may affect the continued operation of the business including economic downturns, loss of market share to competitors and regulation risks and generally these risks are not covered by insurance.

Insurable risks are often described as fortuitous, that is they may or may not happen and are susceptible to relatively precise mathematical analysis.

- 3 While shareholders or owners have the ultimate authority over a business, the board selects a CEO to be responsible for the running of the company, and the CEO, in consultation with the board, in turn appoints the senior management. They appoint their subordinates and assign the tasks for which they become responsible, i.e. have a duty to carry out.

This process cascades down to the most junior employee. In this way a line of authority to make decisions and carry out actions on behalf of the company stretches from the shareholders all the way down through the organisation. Once someone has accepted responsibility for a task they become accountable to the person who assigned it to them, i.e. they are required to report and explain their performance. It should be noted that authority can be delegated to someone further down the line but responsibility cannot.

Chapter 8

self-test answers

- 1 SWOT analysis – strengths, weaknesses, opportunities and threats: The areas that this type of analysis might consider include:
 - Where does the business wish to get to in the short, medium and long term?
 - Which markets can and should the business compete in?
 - How can the business perform better than the competition?
 - What resources in terms of skills, assets, finance, relationships, technical competence, and facilities are required?
 - What are the values and expectations of those who have influence in and around the business?
- 2 Segmentation is essentially the identification of different groups and buyers within a market that share similar qualities and demonstrate similar buying behaviour. The segmentation process aims to match these distinct groups with the products and services provided by your business.
- 3 The most prominent advantage is the fact that it often saves money. Many of the companies that provide outsourcing services are able to do the work for less money. They can do this because:
 - the tasks are carried out in low-cost locations, particularly overseas where salaries and benefits are relatively low compared to the UK and there is an availability of suitable skills; and/or
 - the contractor gains efficiency from specialisation and economy of scale, for example, a catering contractor will be able to source food far more economically, or an outsourcing contractor may have a number of similar contracts with different phasing of demand that enables the work to be done with fewer people.

However, today many businesses recognise that while saving money is important, the key benefit is that outsourcing allows companies to focus on their core competencies and gain from the benefits of specialisation. Often these benefits can far exceed the pure economic savings.
- 4 A set of summarised accounting data (balance sheet, cash flow, and income statement) prepared and presented (usually every month, fortnight or week) specifically for a firm's management. The objective of management accounts is to provide timely and key financial and statistical information required by managers to make day-to-day and short-term decisions.

Chapter 9

self-test answers

- 1
 - Reduced costs as, especially on larger accounts, less people are needed and the 'infrastructure' required by each specialist division is centralised.
 - More consistency of the communication of the client's risk details to insurers as the information is passed through fewer hands.
 - The client knowing that the service team is also conducting all the negotiations rather than passing them off to another division.
 - Consistency of service: service delivery is controlled by one team rather than relying upon the various divisions of the broker performing to the same service standard.
- 2
 - Gives the insurer access to a market that they otherwise would find difficult to enter.
 - Access to underwriters who have a specialist understanding of a certain group of risk may not be cost-effective to obtain.
 - Reinsurers use them so as not to appear as though they are competing with the direct market for whom they also provide reinsurance capacity.
 - To offer a different proposition for small brokers.
 - The volume of business from an individual line of business may be uneconomic for the insurer to do themselves.
 - Availability of skilled MGA resource.
 - As a marketing device to secure an income stream.
- 3
 - Sharpens competitive edge with clients and prospective clients.
 - Enhances business performance by improving skills.
 - Promotes regulatory compliance especially with T&C.
 - Evidence of professionalism.
 - Helps to attract and retain talent.

Chapter 10

self-test answers

- 1 Under Solvency II, ORSA is a written report to the regulator providing an economic view of the capital needed to run an insurer's business, irrespective of the regulatory requirements. Additionally, ORSA provides a forward-looking perspective that should support the business strategy. The insurer is expected to stress and scenario test the ORSA, and this in turn is expected to drive the contingency planning process.

It has also been described as 'a road map for a forward-looking assessment of capital and solvency position across a wide range of risks and is designed to ensure that an organisation's solvency needs are met at all times. Since this is the organisation's own view of economic capital, the ORSA report also plays an important role in rating agencies' financial strength evaluations'.

- 2
- As a prelude to the insolvency of an insurer, problems with claims are likely, with inevitable consequences for brokers and their clients.
 - If an insurer fails the consequent replacement of risks will generate considerable, and in all likelihood, unpaid additional work. When the Independent failed in June 2001 thousands of personal and commercial insurances had to be re-placed at great expense.
 - As a result of the Independent failure many insureds were without cover for times varying between a day and, in some cases, weeks and months. Naturally, this had a major impact on the reputation of the profession as a whole.
 - When an insurer fails premiums paid are lost and brokers will often lose brokerage and fees if these are payable in instalments or on a performance basis.
 - Risks that have to be re-placed are generally done at higher, and in some cases punitive, premiums. This creates client dissatisfaction and the need for further re-broking at renewal.
 - Dealing with claims against insolvent insurers is much more time consuming. Their administrators adopt a very legalistic approach in order to minimise the amount that the 'estate' is due to pay. In many cases claim settlements may be for far less than 100%, often less than 20%. This makes the whole process even more frustrating and expensive for the client and the broker.
 - Recommending an insurer that becomes insolvent can permanently damage a broker's reputation, even if there is no liability.
 - When the Independent failed many clients refused to pay brokerage or fees on re-placed business and became awkward over monies unconnected with the Independent. Some actually sued brokers which resulted in expensive defence costs.

- 3 Although frequent reference is made to 'approved' insurers, in practice brokers prefer not to use such terms as they may imply some form of guarantee. It is the function of regulators to 'approve' insurers. In classifying an insurer for use by the broker, it is saying that an insurer meets the minimum requirements alongside its peers and is equally likely to be able and willing to pay claims compared with other insurers.

Instead there will be some form of guide that states how and in what circumstances different insurers can be used along these lines:

- An insurer may be used on an unrestricted basis for any type of business that it chooses to underwrite.
- An insurer may only be used in a restricted fashion which could relate to:
 - geography;
 - types of business;
 - a requirement that the insured be provided with prescribed information about the insurer and acknowledges receipt of such information, this may include press releases, statements by rating agencies or the broker's summary of events affecting the insurer; and/or
 - a requirement that the insurer can only be used on express instructions from the client – this is only used where the broker does not wish to trade with the insurer.

Chapter 11

self-test answers

- 1 Reduced costs; better returns as earlier costs spread over time; more cross-selling; improved information; problems easier to resolve; referrals.
- 2 Reflects client demands to formalise a key expenditure; reflects good governance and quality systems; explains who is responsible for what; demands from risk and insurance managers; influences of procurement; specify client responsibilities; clarifies broker responsibilities for claims and premium if the appointment ends.
- 3
 - Early warning of any problems that the client is having with the broking service, allowing the broker time to address them.
 - An improved relationship with the client and the demonstration of the broker's interest in their views.
 - Identification of any overall areas of strength or weakness, across all clients. Trends can be identified and used as part of the regular rhythm of managing reporting.
- 4
 - Is the client willing to pay for their broker to provide the claims services?
 - If the broker does not provide a claims service, does this represent value for money for the client?
 - How will they react when they are advised that their claims will be handled by the insurer?
 - If the broker is not involved, how will the quality of claims' service be managed and maintained?
 - If other brokers promise to provide the service, is this a competition issue?

Chapter 12

self-test answers

- 1 Fair reward for added value is a complicated subject. What a broker might consider to be an exceptional value added service, the client might regard as the broker doing their job. Most fees' calculations are naturally biased towards the time that will be spent and the expenses incurred. This can be fine for day-to-day service, but makes very little allowance for those occasions when brokers perform a difficult task successfully due to their market knowledge and experience. Often, this will be done in a short time and as a result is inadequately charged for. It might also be argued that brokers are less confident in charging the 'right' fees in comparison with say, the legal profession. Finally, complaining that competition makes fees uneconomic is special pleading and a sure way to go out of business.
- 2
 - More certain as they are fixed, and thus allow for predictable budgeting.
 - Represent a more professional approach for larger clients.
 - Meet the requirements of clients, especially large and global clients who require complete transparency. The IDD requires mandatory disclosure of the nature of the remuneration, but not the actual figure.
 - They create a framework for the broker to charge for additional services.
 - They are a direct reflection of work done.
 - They are transparent.

Chapter 13

self-test answers

- 1 This means that someone who is not involved in the origination of the work checks another person's work. This is because it is recognised that it is much more difficult for the person who has been heavily involved in a task to spot errors, or even see there is anything wrong, because they are too close to the work. Of course this is not foolproof, as it is quite possible for two people to miss the same error. It is also only effective when there are robust procedures to ensure quality before the SPOE and where the staff carrying out the SPOE have the time and experience to do it effectively. Such a review should be checking for quality and if the reviewer does not have the professional knowledge and expertise to evaluate the advice or statements given, then this approach will default to checking a process, i.e. that the letter went out at the correct time and not that its contents were correct. The pensions mis-selling episode is an example of a correct process being followed but with the wrong conclusion.

The SPOE system can also be compromised if fundamental information is incorrect. For example, a policy register page or an underwriting submission will contain sums insured and other factual statements about the risk. Except in the event of a detailed audit, it is not practical for the reviewer of a piece of work to check this factual information. However, spot checks of some information are a valuable addition to this method of checking.

This method of supervision clearly works best in an environment where people can admit mistakes and where senior staff regard the coaching of more inexperienced staff to be a vital part of their job.

- 2
- Uncontrolled filing by individuals using personal as opposed to group folders.
 - Uncontrolled deletion of emails.
 - Uncontrolled export of data and files.
 - Responses by inexperienced staff.

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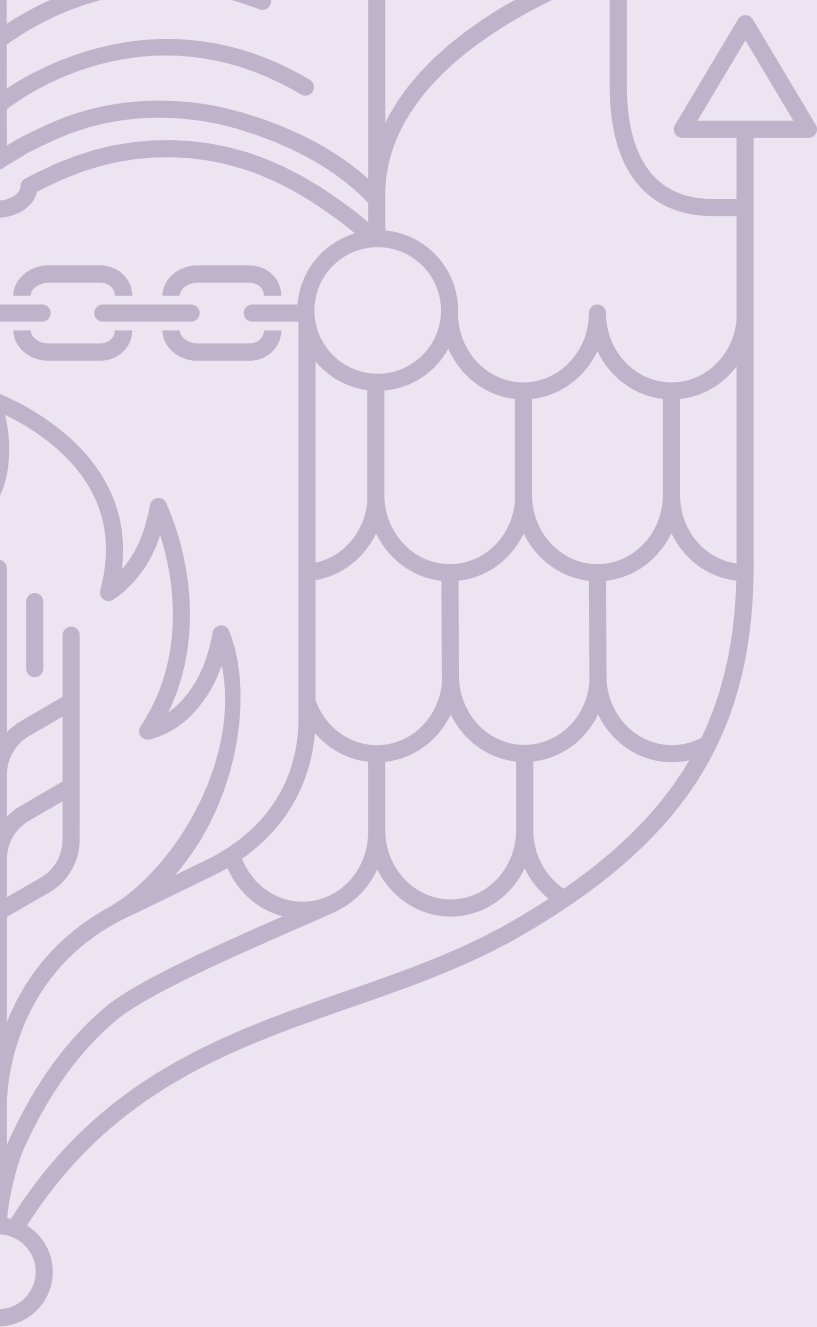
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Ref: 930TB

