

18 November 2005

Our Ref:

Your Ref:

Dear Chief Executive,

CONFLICTS OF INTEREST

We are writing to Chief Executives and those individuals responsible for apportionment and oversight at general insurance intermediaries supervised within our Wholesale and Retail Business Units. This is to remind you of your responsibilities to implement appropriate processes to enable your firm to manage conflicts of interest effectively. This letter also summarises the findings of the study we carried out during the first half of 2005 into current market practice on the identification and management of conflicts of interest.

We will publish a copy of this letter on our website on 24 November 2005.

The management of conflicts is an important factor in the business of insurance intermediaries, and has been the subject of greater focus by regulators around the world, particularly in the United States. The outcome of our review into existing market practice suggests that firms have work to do in order to ensure that they identify and mitigate conflicts of interest more effectively. Our study consisted of a series of visits to firms in the wholesale and retail sectors, comprising interviews with senior management and reviews of systems and controls. We visited 38 firms, in addition to the work we undertook with firms during the course of formal risk assessments. The findings are set out in detail in the attached Appendices but the main points may be summarised as follows:

- **The process for identifying and mitigating conflicts of interest is not, in most firms, sufficiently developed at present.** Senior management should be engaged fully in all aspects of conflicts identification and management and take a broad view of the risks posed to their business. This means that responsibility for conflicts identification and management is allocated clearly to accountable individuals, and that controls to mitigate conflicts are reviewed on a regular basis. Relevant management information should be available to support this process.

- **Firms often perceive conflicts of interest in too narrow a manner, and some firms consider conflicts to be solely about remuneration.** Senior management are responsible for ensuring that the broad spread of conflict risk to which their firm is exposed is addressed, including latent and emerging conflicts. They should also make informed judgements about the materiality of the conflict risk. This should take place within a business culture that supports the management and mitigation of conflicts of interest.
- **While avoiding conflicts is linked with observation of the duties of agency, intermediaries should also ensure that they consider the wider issue of dealing with clients in a manner that is fair and seen to be fair.** We expect firms to take a critical view of how conflicts may affect the fair treatment of clients and to respond accordingly, consistent with our Treating Customers Fairly (TCF) initiative. Clear guidance should be in place for staff on how to recognise a potential issue and when to escalate matters to senior management. More information on TCF, including a case study on conflicts management, is available at www.fsa.gov.uk/tcf

In light of the above, we expect the following actions to take place at all firms:

- Boards should review the current and potential conflicts to which their firms are exposed;
- a formal conflicts policy should be put in place or, where already in place, reviewed, with firms setting out clearly how they propose to mitigate the conflicts identified; and
- firms must tell their FSA supervisory contact the outcome of the above steps by Friday 20 January 2006.

We are planning further work during 2006 on the arrangements in place within intermediaries to manage conflicts of interest, particularly in relation to commercial customers. Commercial customers at present have the right under our rules to request details of commission paid to brokers, but our review suggests that, in practice, few in fact make such requests. We will use the results of this work, and the findings of the current study, to assess whether there is a case to amend our policy for commercial customers to introduce the compulsory disclosure of commission and, if so, whether to make this binding on both intermediaries and insurance companies. We would do this alongside our wider review of the impact of the Conduct of Business regime of General Insurance Intermediaries, which is due to begin in April 2006. In line with the guidance issued during February 2005, we do not believe that there is currently a quantifiable market failure in this area which requires regulatory intervention. However, our view is clearly linked to how much we are able to rely on the rigour of conflicts management processes within intermediary firms.

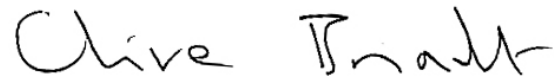
In the meantime, we are aware that a number of intermediaries have already made significant changes to the degree of transparency paid in this regard. We support this and other market-led initiatives to introduce a level of consistency on the timeliness and content of what is disclosed to customers in this regard. Moreover, there is nothing in our rules which prevents an insurance company from choosing to disclose directly to its customers what level of commission it pays to brokers.

We would like to thank those firms involved in the project for their cooperation. If you have any further comments or questions, in the first instance please speak to your usual supervisory contact.

Yours faithfully,

Handwritten signature of Hector Sants in black ink.

Hector Sants
Managing Director
Wholesale & Institutional Markets

Handwritten signature of Clive Briault in black ink.

Clive Briault
Managing Director
Retail Markets

Appendix A

QUESTIONS FOR FIRMS TO CONSIDER IN RESPONDING TO THIS LETTER

In reviewing or developing a conflicts policy in response to this letter, the following observations from our review might provide a useful framework for senior management. It is emphatically not general guidance or guidance on rules: it is for each firm to consider whether these observations are appropriate to its own circumstances given the size of the firm and the size, range and type of business it undertakes.

- ***Senior management should be engaged fully in all aspects of conflicts identification.*** Has responsibility for conflicts identification and management been allocated clearly to accountable and appropriately senior individuals? Is this formally documented and approved by the Board? How often are these arrangements reviewed to ensure both consistency and compliance and by whom?
- ***Senior management should take a holistic review of conflicts management.*** How do senior management demonstrate that there is regular and systematic review of conflicts both within and across business lines? Can the Board point to a rigorous method used to identify the drivers of conflicts, the outcomes that need to be avoided and the controls designed to achieve this? Does the Board review this to ensure that the method does not relate simply to issues of remuneration and, if so, with what frequency?
- ***Senior management should review the performance of conflicts mitigation strategies.*** What management information is produced, by/for whom and with what frequency, to detail compliance with the mitigation strategies that have been put in place? How often is this reviewed by functions independent of the front office (i.e. Internal Audit or Compliance) and how often is performance reviewed by the Board? Do senior management critically review business practices and consider whether conflicts are being managed properly – which does not necessarily mean being in line with standard industry practice?
- ***Senior management should have policies and practices in place for compensation and training and a firm's culture should support conflict management and mitigation.*** Can the firm demonstrate explicit consideration of adherence to conflict procedures during staff appraisals? Do they hold regular training with respect to conflicts and the firm's code of ethics, both at induction and in the form of refresher training, which would assist in embedding the firm's values and control procedures amongst staff?

Appendix B

SUMMARY OF FINDINGS FROM VISITS

The study distinguished between fundamental conflicts, i.e. those most likely to cut across the duty of agency owed by the intermediary to its client, and other issues which had the potential to cause detriment to the client but which did not necessarily result in a fundamental breach of agency principles.

1 Summary

The findings in respect of fundamental conflicts can be summarised as follows:

- Most wholesale firms did not have any specific procedures or formal controls to ensure that staff did not solicit quotations from insurers that were intentionally higher (or otherwise less favourable) than quotes provided by other insurers. This conflict may emerge where the intermediary is incentivised to place a risk with a particular insurer, usually because of a favourable commission rate or other payment; this may be less of an issue for retail firms, where commission rates are not always known to client-facing staff, and where products are more commoditised. Mitigation strategies, where they existed, tended to be effected by ensuring that clients were always informed of which insurers have been approached, readily comparable details of all quotes were communicated to the client and put to file, and a file acceptance check was carried out post-inception.
- When arranging commission sharing agreements with senior business-producing staff, rates of personal commission may encourage the recommendation of insurances based on the earnings potential for the individual rather than on the suitability of the product for the policyholder. There is a particular risk inherent in (generally wholesale) firms where it is commonplace for business producers to retain a relatively high percentage of the brokerage earned on each placement. Most intermediaries assumed that this conflict was not relevant to them because they believed that if the price quoted was not competitive then they would not win the business. Whilst this may be the case in some lines of business, there are some markets where gross levels of commission are very high in proportion to the overall price of the product and, thus, there is more room for the pricing of the product to be structured in a manner that maximises the individual broker's remuneration. Mitigation strategies observed were similar to those of the example above.
- Amongst retail firms there was a greater likelihood for conflicts to exist in respect of close links with an insurer. In some cases this was partially mitigated by management information that identified the proportion of business placed with the linked insurer(s), which permitted senior management to identify any unusual placement volumes or patterns. There was, however, little evidence in some cases of formal procedures to ensure that the broker's duty to the client was not being compromised by the relationship with the insurer. Mitigation strategies for firms in this position included further consideration of whether formal business placement procedures

should be effected that addressed specifically the issue of close links. Robust compliance monitoring arrangements, and measures to improve the impartiality of decision-making arrangements in respect of access to the intermediary's panel, also formed part of some approaches to mitigation.

2 Other issues observed

A number of issues arising from the study demonstrated further the need for firms to reconsider how they identify and mitigate conflicts of interest:

- **Reinsurance conflicts** – firms looking to expand reinsurance division operations saw the potential to use the placement of direct business as a means of encouraging insurers to use the intermediary for the placement of outwards reinsurance. Hence, there was a clear conflict between the generation of business from one client and the interests of the client whose business was being used as a 'bargaining chip'.
- **Close links** – in addition to the finding set out above relating more specifically to retail firms it was found that where companies associated to intermediaries provided services to policyholders (such as consultancy/advisory operations), the intermediary did not always have systems and controls in place to ensure that referrals were carried out on a commercial 'arm's-length' basis. Such associated firms may also handle confidential information on behalf of policyholders or their competitors and there were few examples of good practice in respect of 'Chinese walls' being operational.
- **Personal conflicts** – Whilst most firms had in place a formal policy with regards to the trading in shares of clients or insurers, conflicts would only be considered to arise in the event of a very significant shareholding in the entity concerned. For example, there may only be considered to be a conflict of interest if the equity participation was a significant proportion of the voting capital of the company.
- **Claims handling authorities** – where the intermediary is permitted to place insurers on risk under a delegated underwriting authority, there is sometimes an equivalent claims handling authority with the same person. Intermediaries with binding authorities are often remunerated in accordance with the volume and profitability of the underlying business, meaning that they may be incentivised to handle claims to the detriment of policyholders. Whilst most binders have limited claims settling authorities, meaning the potential for the conflict to generate policyholder detriment is reduced, some scope for conflict remains.

3 Inducements

Wholesale intermediaries are aware of the potential for conflicts of interest to arise out of inducements and remuneration and identified this conflict in most cases. Formal mitigation strategies, however, are poorly developed. Many firms considered such conflicts to arise solely from the operation of profit sharing arrangements (PSAs), and whilst some intermediaries have eliminated these arrangements from their business models, the existence of PSAs continues elsewhere in the market. Many retail firms did not consider the issue of

inducements to be a high risk conflict given the nature of their business, and whilst this is the case to a certain extent, it is an area that such intermediaries should continue to monitor.

Most firms had some form of strategy in place to deal with inducement related conflicts, although these strategies did not always mitigate the risk to acceptable levels. Mitigation strategy generally relied on the policyholder being relatively price sensitive and on disclosure where the intermediary had not been able to obtain quotes from a wide spread of risk carriers. Intermediaries stated that commercial clients very rarely asked for commission to be disclosed but that in those instances where the request was made it was not complicated for the firm to identify and release the commission details. This suggests, albeit anecdotally, that there is not currently a pent-up demand for commission details even amongst sophisticated insurance buyers.

The following examples of inducement-related conflicts arising out of the present study, in addition to the two set out above, were noted:

- ***Binding authorities*** – where an intermediary operates a binding authority with a profit commission, there is an inherent conflict whereby business the intermediary knows to have a good loss history may be directed to the binding authority whilst other business is directed to other markets. This conflict is sometimes mitigated by operating the binding authority on an 'arm's-length' basis, or under a separate division, however, this practice is not prevalent across the market.
- ***Lineslips*** – many intermediaries in the Lloyd's market operate lineslips, usually including profit commission arrangements. There is a risk that business is directed onto the lineslip, which may contain most of the market leaders in that line of business, without being shown to the underlying markets separately (where underwriters may offer more favourable terms than the lineslip leader in order to secure a larger share of the business). Whilst some firms operated a 'client's best interests' policy in such circumstances, this was found to be by no means universal.
- ***Premium finance*** – an intermediary may be involved in premium financing through ownership or participation in a premium finance provider, or through interest/administration charge sharing arrangements with such a provider. The risk is that policyholders may be encouraged unduly to use the premium finance services, or where they elect to use premium finance, are obliged so to do through the broker's preferred supplier. Most intermediaries had written procedures to mitigate this risk, but this practice was not universal and some intermediaries saw this as a legitimate means of earning additional income through their business.
- ***Soft loans & cash gifts*** – Product providers have, in some cases, been willing to make large gifts or uneconomic (soft) loans to intermediaries. Such gifts or loans may be construed as being in return for the provider's products being placed on the intermediary's panel or recommended list of insurers. In some cases the gift or loan is given on condition of a target for the sale of the provider's products. Such an arrangement is incompatible with the adviser's duty to recommend the most suitable

product within its range. Disclosure of the gift or loan to clients was not found to be universal.

4 Conflict mitigation and market practice

Most wholesale intermediaries had developed, or are developing, strengthened procedures to help identify and mitigate conflicts of interest. This, however, is a recent phenomenon taking place largely within the context of PSAs and reciprocity arrangements with insurers. Retail intermediaries were less likely to have developed a formal conflicts of interest policy, and mitigation of conflicts tended to take place in a piecemeal manner, or as part of a control principally designed to mitigate some other risk. Some retail intermediaries, at the time of the study, had not started the process of thinking about conflicts and did not believe they were exposed to any risk. Set out below are a number of features of conflicts mitigation procedures and practice found during the study:

- Some conflicts policies started with an attempt to define what constituted a conflict. Firms should consider whether a definition may be either too narrow (i.e. tied to remuneration issues) or too general (i.e. a conflict is where the interests of the intermediary differ from the interests of the client). An alternative approach was to start with a general definition of a conflict of interest followed by an analysis of how this may apply in common business situations.
- An attempt was made in some procedures to tie all documents relating to personal and corporate conflicts into one overarching framework. Other approaches had an array of different conflict-related documents (i.e. principles for dealing with clients, Board conflicts policies, staff ethics guides, etc.) that were not always consistent with one another. An alternative approach to handling conflicts was to start with a high level conflicts framework, with subsequent consistent sub-manuals relevant to the appropriate business area.
- Whilst all staff in an intermediary should be aware of conflicts and should be responsible for ownership of conflicts arising out of their own conduct, the overall conflicts policy should be owned by a member of the Board, with regular reporting backed by strong management information highlighting exceptions. In some cases, firms did not have a director responsible for the conflicts policy, and reports to the Board were sporadic or only on a case-by-case basis.
- Most smaller intermediaries did not have an internal audit (IA) function. Where an IA function is not present, a strong culture of consistent internal acceptance checking of files by an individual not involved in the placement of the risk is one method of ensuring that risks arising out of conflicts have not crystallised. The approach of some small firms to handling conflict identification was regular file reviews with senior staff showing a serious approach to making sure exceptions are monitored, followed up, and managed effectively.