Discussion Paper

08/2

Financial Services Authority

Transparency, disclosure and conflicts of interest in the commercial insurance market

March 2008
# Contents

1 Overview 3
2 Background 7
3 CRA’s report 12
4 Our concerns about the market 16
5 Potential solutions 24

Annex 1: List of Questions
Annex 2: Illustrative Draft Rules
Annex 3: High-level Cost-Benefit Analysis (CBA)
The Financial Services Authority invites comments on this Discussion Paper. Please send us your comments by 25 June 2008.

Comments may be sent by electronic submission using the form on the FSA’s website at (www.fsa.gov.uk/Pages/Library/Policy/DP/2007/dp08_02_response.shtml).

Alternatively, please send comments in writing to:

Alison Phillip  
General Insurance Policy  
Financial Services Authority  
25 The North Colonnade  
Canary Wharf  
London E14 5HS

Telephone: 020 7066 5198  
Fax: 020 7066 5199  
E-mail: dp08_02@fsa.gov.uk

It is the FSA’s policy to make all responses to formal consultation available for public inspection unless the respondent requests otherwise. A standard confidentiality statement in an e-mail message will not be regarded as a request for non-disclosure.

A confidential response may be requested from us under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Tribunal.

Copies of this Discussion Paper are available to download from our website – www.fsa.gov.uk. Alternatively, paper copies can be obtained by calling the FSA order line: 0845 608 2372.
1 Overview

1.1 In this Discussion Paper (DP), we explain our concerns about transparency, disclosure and conflicts of interest in the commercial insurance market and invite views on these, and on possible options for addressing them.

1.2 Our aim is to identify how best to ensure that commercial insurance customers are appropriately protected and that this market operates in an efficient, orderly and fair manner.

1.3 This DP follows the publication, in 2007, of two reports which looked at the commercial insurance market. The first of these reports, published in September, was produced by the European Commission, following its competition inquiry into business insurance. The second, issued in December, was an independent piece of research that CRA International (CRA) carried out on our behalf, which focused primarily on commission disclosure.

1.4 Both pieces of work found evidence of a lack of transparency in the commercial insurance market in relation to intermediary remuneration and services, which could give rise to customer detriment and impair market efficiency.

1.5 CRA’s report took the form of a market-failure and cost-benefit analysis on the specific question of whether we should mandate commission disclosure. CRA concluded that the benefits of introducing such a rule by itself were not justified by the costs because the benefits would be concentrated on middle-sized customers. However, in the course of that work, CRA identified a wider set of issues affecting the efficiency of this market.

1.6 In this DP, we consider these wider issues and explore how best to address them in a proportionate manner.

1.7 There are three key pieces of information that we believe commercial customers need to have when making decisions about their insurance intermediary:

- **Remuneration**: How much the intermediary is paid for mediation activities (as distinct from the risk transfer cost);

- **Services**: What services the intermediary provides; and
• **Status / Conflicts of interest**: On whose behalf the intermediary is acting, including what, if any, conflicts of interest he may face.

1.8 We also highlight three conditions that we consider necessary to achieve full transparency:

• **Clarity**: Information should be clear and accurate.

• **Comparability**: Information should be presented (and calculated) in a way that facilitates comparisons across the market and over time.

• **Accessibility**: Information should be clearly available.

1.9 In our view, full transparency of information is necessary to enable customers to operate more effectively in this market. This could bring about a more competitive environment that encourages greater market efficiency and creates a downward pressure on prices.

**What are our concerns?**

1.10 The evidence we have suggests that, in some respects, current market practice is falling short of these standards.

1.11 Specifically, we are concerned that commercial customers appear to be poorly informed about:

• the full cost of mediation services – in particular, the extent of contingent commissions and the amount of remuneration earned by other intermediaries in the chain;

• the extent to which their intermediary searches the market; and

• the capacity in which their intermediary is acting – whether on their behalf, the insurer’s, or both.

1.12 Where commercial customers are receiving commission information, it is not always in a form that enables them to compare the services and costs of one intermediary with another’s on a like for like basis.

1.13 There also seems to be continuing uncertainty among firms about the remuneration arrangements they must disclose – and this is being exacerbated by the increasing use of business models which blur the roles of insurers and intermediaries.

1.14 Finally, we need to satisfy ourselves that any conflicts of interest arising from intermediaries’ commission arrangements /relationships with third parties are being properly managed.

**What outcomes do we want to see?**

1.15 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 (see below), 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 – ie 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.

Potential solutions

1.16 We identify three broad – and potentially cumulative – options for addressing our concerns:

- **More rigorous supervision and enforcement of our existing rules and principles** – ie further guidance on what is expected, plus more targeted supervision, supported by additional reporting requirements (to the FSA) about remuneration arrangements and business models likely to create conflicts of interest, and the processes firms have in place to deal with these.

- **Enhanced ‘on-request’ regime** – ie introduce measures designed to improve the transparency and comparability of disclosure requirements relating to remuneration, services and status within the existing framework (both for ‘on request’ and voluntary disclosures).

- **Mandatory commission disclosure** – ie introduce the measures described under the previous option but, in addition, require commission disclosure to be made automatically, rather than on request.

1.17 However, each of these would need to be supported by improved conflict management processes. And we think they could be usefully complemented by an education initiative aimed at helping commercial customers to understand the value of commission information and use it more effectively.
1.18 The possible solutions considered in this paper are not necessarily mutually exclusive – various permutations are possible. Most could be introduced either via regulatory means or through industry agreement/codes. We remain keen to encourage a market-led solution if possible, although we recognise that views on this issue are polarised. We describe progress on this front in Chapter 5.

Wider programme of work

1.19 In parallel with this DP, we are conducting additional work to inform our thinking.

- **Thematic work:** We are conducting a detailed survey of intermediaries’ remuneration arrangements and business models in the commercial insurance market. We will investigate the nature and extent of the conflicts of interest to which these give rise and the effectiveness of the mitigation practices intermediaries employ to address them.

- **Customer research:** This work will look at how commercial customers use information about intermediary commission and services. It will also test how to optimise their use of this information (including the impact of oral disclosure requirements and prescribed formats).

Structure of this paper

1.20 In Chapter 2, we describe the background to this DP, including the key legal and regulatory requirements to which the industry is already subject. In Chapter 3, we provide a brief synopsis of CRA’s findings. In Chapter 4, we set out our key concerns and the outcomes we want to achieve. We also highlight relevant trends in the market – in particular, the move towards greater consolidation and vertical integration. And in Chapter 5, we outline a range of potential solutions (both regulatory and market-led).

Next steps

1.21 We invite comments on this paper by 25 June 2008. To assist respondents, we have included a list of questions in Annex 1. We would encourage respondents to provide corroborating evidence for their views wherever possible.

1.22 Feedback from this DP and the results of our additional work will help to inform our decision on whether to make changes to our rules or supervisory practices. If we decide rule changes are necessary, we will formally consult in the fourth quarter of 2008.

1.23 This DP is aimed at all insurers and intermediaries carrying out business in the commercial insurance market – large or small, and operating in the London or regional markets. We would also welcome views from relevant trade bodies, market participants, commercial customers and other interested parties.
2 Background

2.1 In this chapter, we briefly summarise the existing legal and regulatory framework and describe the background to our current programme of work on transparency, disclosure and conflicts of interest.

Legal framework

2.2 The statutory provisions underpinning our rules on remuneration disclosure in the commercial insurance market can be found in both civil and criminal law.

2.3 Under the law of agency, an agent owes certain duties of loyalty (fiduciary duties) to those he acts for, including his customers. In particular:

- an agent must avoid conflicts of interest. He must not put himself in a position where his own interests conflict in any way with his duty to those he acts for, including his customer. Nor must he put himself in a position where the interests of one person for whom he acts conflict with the interests of another person for whom he also acts; and

- an agent must not take a secret profit: he may not use his position to acquire a benefit from a customer or a third party.

An agent can avoid breaching these duties if he obtains the fully informed consent of the person (s) for whom he acts before he does so.

2.4 In addition to the general civil law duty requiring the agent to account to their principal, criminal sanctions may follow where an agent is guilty of corruption. An agent commits a criminal offence if, in relation to the affairs of his principal, he accepts a bribe for:

- doing, or failing to do, something, or

- favouring, or not favouring, a person.

The person offering the bribe also commits a criminal offence.

2.5 Generally speaking, if the principal leaves the agent to look for remuneration from the third party (ie he does not pay a fee for the agent’s services), or knows that the
agent will receive something from the third party, then the agent may safely take commission from third parties for his services. However, if the principal pays a fee to the agent, any undisclosed commission (so-called ‘secret commission’) paid to the agent by a third party could be taken as evidence of corruption.

**Regulatory requirements**

2.6 The FSA Handbook builds on this statutory framework. The relevant high-level FSA Principles are 1, 6, 7, and 8. These are supported by a modest amount of rules and guidance, mainly in the Insurance Conduct of Business Sourcebook (ICOBS).

2.7 The key rules in relation to the remuneration of general insurance intermediaries are:

- **ICOBS 4.3.1R: Fee disclosure**

  ‘A firm must provide its customer with details of the amount of any fees other than premium monies for an insurance mediation activity. The details must be given before the customer incurs liability to pay the fee, or before conclusion of the contract, whichever is earlier. To the extent that an actual fee cannot be given, a firm must give the basis for calculation.’

- **ICOBS 4.4.1R: Commission disclosure**

  ‘An insurance intermediary must, on a commercial customer’s request, promptly disclose the commission that it and any associate receives in connection with a policy. Disclosure must be in cash terms (estimated, if necessary) and in writing or another durable medium. To the extent this is not possible, the firm must give the basis for calculation.’

**Unfair inducements**

2.8 We also have an explanatory piece of guidance (in ICOBS 2.3.1G) on how our Principles (1, 6, and 8) relate to the accepting and receiving of inducements.

‘(1) Principle 8 requires a firm to manage conflicts of interest fairly, both between itself and its customers and between a customer and another client. This principle extends to soliciting or accepting inducements where this would conflict with a firm’s duties to its customers. A firm that offers such inducements should consider whether doing so conflicts with its obligations under Principles 1 and 6 to act with integrity and treat customers fairly.

(2) An inducement is a benefit offered to a firm, or any person acting on its behalf, with a view to that firm, or that person, adopting a particular course of action. This can include, but is not limited to, cash, cash equivalents, commission, goods, hospitality or training programmes.’

---

1 Principle 1: A firm must conduct its business with integrity.

Principle 6: A firm must pay due regard to the interests of its customers and treat them fairly.

Principle 7: 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.

Principle 8: A firm must manage conflicts of interest fairly both between itself and its customers and between a customer and another client.

2 ICOBS 4.4.1R applies only to the intermediary who is in direct contact with the commercial customer, as other brokers in the chain do not have a customer relationship with the commercial customer.
2.9 Also relevant to the wider issue of status disclosure and the management of conflicts of interest are the following FSA rules:

- **ICOBS 4.1.2R: Status disclosure**

  ‘Prior to the conclusion of an initial contract of insurance and, if necessary, on its amendment or renewal, a firm must provide the customer with at least: its name and address, the fact that it is included in the FSA Register and the means for verifying this; whether it has a direct or indirect holding representing more than 10% of the voting rights or capital in a given insurance undertaking (that is not a pure reinsurer); whether a given insurance undertaking (that is not a pure reinsurer) or its parent undertaking has a direct or indirect holding representing more than 10% of the voting rights or capital in the firm; and the procedures allowing customers and other interested parties to register complaints about the firm with the firm and the Financial Ombudsman Service or, if the Financial Ombudsman Service does not apply, information about the out-of-court complaint and redress procedures available for the settlement of disputes between the firm and its customers.’

- **ICOBS 4.1.6R: Scope of service**

  ‘Prior to the conclusion of an initial contract of insurance and, if necessary, on its amendment or renewal, a firm must tell the customer whether: (a) it gives advice on the basis of a fair analysis of the market; or (b) it is under a contractual obligation to conduct insurance mediation business exclusively with one or more insurance undertakings; or (c) it is not under a contractual obligation to conduct insurance mediation business exclusively with one or more insurance undertakings and does not give advice on the basis of a fair analysis of the market. A firm that does not advise on the basis of a fair analysis of the market must inform its customer that he has the right to request the name of each insurance undertaking with which the firm may and does conduct business. A firm must comply with such a request.’

2.10 The industry has also produced a range of complementary guidance designed to help regulated firms comply with their legal and regulatory obligations.³

### Background

2.11 Our current ‘on-request’ commission disclosure rule is broadly based on common-law requirements, which require an insurance intermediary, when acting as a fiduciary, to disclose commissions earned to its customer on request.⁴ However, in the light of consultation with the industry, we extended the scope of this requirement to include cases where the intermediary may not be acting as a fiduciary. The rationale for this was to ensure that market abuses, such as

---

³ Examples include LMBC’s Statement of Legal and Regulatory Practice (currently under review) and guidance produced by BIBA including: Managing Conflicts of Interest (2005), Managing Conflicts of Interest – Supplemental BIBA Guidance Note (2006) and Requests For Commission Disclosure – A Process (2008).

⁴ (unless the intermediary is also receiving a fee, in which case, he should disclose automatically).
‘grossing up,’\textsuperscript{5} could be prevented. It was also felt that commercial customers, unlike retail customers, would be better able to use commission information when negotiating terms with their intermediary.

2.12 Shortly before the introduction of general insurance mediation regulation in the UK in January 2005, Eliot Spitzer, the New York State Attorney General, brought actions in the United States against some of the world’s largest insurance intermediaries on allegations including ‘bid-rigging’ and collusion. The largest international intermediaries now adopt a world-wide policy of voluntarily disclosing commission information automatically. They also decided to stop using certain forms of remuneration linked to the volume or profitability of business placed with insurers (‘contingent commissions’) which can give rise to conflicts of interest.

2.13 In February 2005, we issued guidelines to FSA-regulated firms setting out our expectations in relation to unfair inducements and conflicts of interest in the general insurance market.\textsuperscript{6} Later that year, we initiated thematic work to investigate how general insurance intermediaries were identifying and managing conflicts of interest. This work found that many firms’ processes for identifying and mitigating conflicts of interest were inadequate and that they tended to perceive conflicts too narrowly – with some firms considering only conflicts arising from remuneration. We voiced our concerns in a ‘Dear CEO’ letter to firms in November 2005\textsuperscript{7} and announced plans for follow-up work which would assess firms’ processes and test the quality and robustness of their conflict management arrangements. We also notified firms that in light of this further work, we would consider introducing mandatory commission disclosure.

2.14 We carried out the second phase of thematic work during 2006. This focused specifically on conflicts management in relation to commercial business and commission disclosure. It found that firms had generally made good progress in establishing policies and procedures to identify and manage conflicts in response to the 2005 ‘Dear CEO’ letter, though some firms had not fully embedded these practices in their day-to-day business operations.

2.15 However, our findings regarding compliance with our commission disclosure rules were less encouraging. We found a widespread lack of formal processes among intermediaries as to what was disclosed to commercial customers on request, with some intermediaries failing to include all forms of commission, in particular, contingent commissions. In December 2006, we sent a further ‘Dear CEO’ letter\textsuperscript{8}, reminding firms that all forms of commission had to be disclosed on request.

\textsuperscript{5} Grossing up takes place where the gross premium (including commission) agreed between the intermediary and insurer is less than the premium amount which the intermediary tells the customer is the premium payable. The difference between the two amounts is kept by the intermediary, and the customer is not aware that he is paying a greater sum than has been agreed between the intermediary on his behalf with the insurer.


\textsuperscript{7} Dear CEO letter, Conflicts of interest. http://www.fsa.gov.uk/pubs/ceo/conflicts_18nov05.pdf

2.16 In the meantime, industry participants called on us to look into the perceived lack of commission transparency, which, they alleged, was creating three potential market failures:

- **Un-level playing field:** International intermediaries (who were disclosing voluntarily) argued that the lack of mandatory commission disclosure gave UK intermediaries an unfair advantage, especially in the regional market.

- **Transparency to the customer:** Few customers are exercising their right to ask for commission information and, where they do, there is inconsistency in what is disclosed.

- **Transparency to the market:** Underwriters in the London market argued that intermediaries should also disclose their remuneration to the insurer – including fees and how commission was split among intermediaries in the chain. They argued that this would help insurers manage conflicts of interest better.

2.17 In response to these concerns, and the emerging findings from the second phase of our thematic work, we decided that a focused, forensic review of commission disclosure in the commercial insurance market was necessary.

2.18 So, in October 2006, we announced our intention to commission an independent market-failure analysis (MFA) and cost-benefit analysis (CBA). We appointed CRA, an economic consultancy, to conduct this work, which began in March 2007. Chapter 3 summarises the results of CRA’s work and explains how this has influenced our thinking about transparency and conflicts of interest.
3 CRA’s report

3.1 In this chapter, we summarise the main findings of CRA’s report⁹ – and we also refer to the European Commission’s Business Insurance Inquiry Report,¹⁰ which identified broadly similar issues.

CRA report

3.2 We asked CRA to look specifically at whether there were any substantive market failures arising from the lack of transparency in commission information (both to the customer and to the market) and if so, whether mandating commission disclosure would be justified on cost-benefit grounds.

Market-failure analysis

3.3 CRA found evidence of market failures arising from the lack of automatic commission disclosure, but mainly in relation to medium-sized firms (those with an annual turnover of between £0.5m and £100m).¹¹ Unlike the smallest firms, these customers typically need complex, bespoke insurances and rely on their intermediary to get it. And unlike the very largest firms (who generally pay on a fee basis) middle-sized customers tend to pay for mediation via commission, including contingent commission.

3.4 CRA concluded that due to the lack of commission transparency, these medium-sized customers could be paying higher commissions than would otherwise be the case. Medium-sized customers were frequently unaware of their right to ask for commission information and those who were aware rarely exercised their right to do so. The evidence also suggested that these customers significantly under-estimated how much they paid their intermediary – by around half, on average.

---


¹¹ For the purpose of their analysis, CRA subdivided the commercial market into three broad segments, defined by the size of the customer. The first related to micro enterprises – small firms with annual turnover of less than £500k. The second was a middle-segment of commercial customers with annual turnover of £0.5m-£100m. The third group comprised large corporate customers (LCCs) with annual turnover greater than £100m.

12 DP08/2: Insurance: transparency, disclosure and conflicts of interest (March 2008)
3.5 However, CRA found no evidence to support market participants’ claims that the lack of disclosure to the market gave rise to significant market detriment. Nor did it find that lack of mandatory disclosure created an unlevel playing-field between the intermediaries who voluntarily disclosed and those who complied with the requirements of the ‘on request’ regime.

Cost-benefit analysis

3.6 In analysing the costs and benefits of mandating commission disclosure, CRA considered a range of different ways in which this could be done. These ranged from simply mandating the current ‘on request’ regime (i.e. disclosure of the customer-facing intermediary’s commission only) to mandating disclosure of commission earned throughout the chain. However, they found that most of these options were likely to lead to significant unintended consequences (in particular, scope for avoidance and regulatory arbitrage). CRA therefore concluded that the most effective scenario (described in their report as ‘Scenario 3a’) involved mandating disclosure of the total amount of commission earned throughout the distribution chain, including the disclosure of contingent commissions in cash terms.

3.7 CRA estimated that the costs of mandating commission disclosure in this way would be £87m one-off and £34m ongoing – equivalent to 0.5% and 0.2% of the gross written premiums respectively. These costs would be split between the insurers, who would bear 45% of the total, and intermediaries who would bear around 55% of the costs. They estimated that regional intermediaries – smaller firms in particular – would bear a disproportionate share of the costs.

3.8 However, CRA found that mandating disclosure would benefit only a fraction of commercial customers, once those who already received commission disclosure (40-50% of the market) and those who were unlikely to use commission information (estimated as 80% of the remaining market) were taken into account. In fact, CRA estimated that the beneficiaries of a mandatory regime would account for only 5% of the total value of commercial insurance (by gross written premium (GWP)) bought each year.

3.9 On balance, CRA therefore concluded that mandating commission disclosure on its own would not be justified on cost-benefit grounds. Their conclusion was underpinned by the following key findings:

- **Customers who already receive commission information would not benefit from mandating it.** According to CRA research, over half the market (defined in terms of GWP) already receives commission information. So while these customers might (as we discuss below) benefit from improvements in the quality and comparability of disclosure (such as clearer information about contingent commissions), CRA concluded that mandating would not, by itself, benefit these customers.

---

12 See page 97 of CRA’s report.
• Smaller clients would not benefit from mandating commission information. At the smaller end of the commercial insurance market, risks tend to be more generic and products more commoditised. As a result, direct insurers have been able to take a 50% share of business in this segment. CRA noted that customers who have access to the direct and mediated channels can already infer the cost of using an intermediary by comparing gross premiums\(^{13}\) between the two, and the competitive discipline this instils helps to keep commission rates to a minimum. So CRA concluded that commission disclosure, on its own, would offer no additional benefits to this group of customers.\(^{14}\)

• The largest customers would not benefit from mandating commission information. CRA found that most (upwards of 80-90%) of the very largest customers in the market pay by fee rather than commission. And where intermediaries do receive commission, these tend, because of the way these large commercial insurance contracts are negotiated, to be transparent to the customer without the need for separate disclosure. As a result, CRA concluded that customers at this end of the market, like customers at the smallest end of the market, would gain no benefit from commission disclosure being made mandatory.

• Only one-fifth of customers would actually use commission information. CRA conducted a customer research survey of over 200 commercial customers to understand how they chose their insurance intermediary. The survey revealed that 81% of customers did not use the commission information they received. CRA therefore assumed that, in the absence of additional measures designed to change their behaviour and improve the quality / comparability of these disclosures, only a small proportion of middle-sized customers would actually use mandated commission information.

3.10 However, in carrying out this work, CRA identified a broader set of issues. These went beyond those which had led us to consider whether to mandate automatic commission disclosure and raised concerns about market efficiency.

3.11 In particular, they noted that customers appeared to have a limited understanding of the capacity in which their intermediary was operating and the extent to which he was acting on their behalf. This was being exacerbated by significant changes in the market, including the use of particular remuneration arrangements and business models which gave rise to significant conflicts of interest (see next chapter). The concern here was that this could be leading to mis-buying, over-consumption of mediation services and inflated distribution costs. However, these issues went beyond the scope of CRA’s work and were therefore flagged as requiring further investigation.

\(^{13}\) Total premium, including commissions.

\(^{14}\) The similarity between the smallest commercial risks and retail risks is evident here, and underpins the rationale for our differentiated approach to commission disclosure between commercial and retail customers. See CP 160 and 187 for further details.
European Commission’s Business Inquiry Report

3.12 The concerns voiced by CRA on the wider issues were similar to those raised by the European Commission’s inquiry into business insurance. This report concluded that the current market environment does not go far enough in protecting intermediaries’ customers. In particular, the lack of transparency of intermediaries’ remuneration was said to inhibit true competition among insurers around product, service and financial strength. The Commission’s report also noted the potential for conflicts of interest arising from intermediaries’ dual role, especially where they act on behalf of insurers under delegated authorities. Full disclosure was perceived to be an important element in managing such conflicts.

3.13 Commission disclosure is therefore now on the European Commission’s agenda for consideration as part of the review of the Insurance Mediation Directive.

3.14 Against this background, we have concluded that we need to take a broader, more holistic view of the issues before deciding how best to address them. This will also put us in a good position to influence the discussion in the European context.
4. Our concerns about the market

4.1 In this chapter we outline our concerns about transparency in the commercial insurance market. These include, but go beyond, transparency of commission disclosure, which was the original focus of CRA’s work. They extend to the transparency of the services intermediaries provide to commercial customers and the capacity in which they act.

4.2 Our concerns about transparency fall into three broad categories:

- clarity;
- comparability; and
- accessibility.

4.3 We also examine the conflicts of interest inherent in certain remuneration arrangements and business models and the role transparency can play in mitigating these. In doing so, we take account of relevant developments and trends in the market which have a bearing on the concerns we have identified and may influence our choice of solution.

4.4 Throughout this chapter, we identify and discuss each of our concerns and then highlight, in a box at the end of each section, the outcome we want to achieve.

Current market developments and trends

4.5 Consolidation among intermediaries, particularly in the regional market, is a notable feature of the current landscape and looks set to accelerate over the next five to ten years. In particular, there has been a noticeable trend for the ‘baby boomer’ generation of small independent intermediaries to retire from the market and for this business to be acquired by large national intermediaries (the so-called ‘consolidators’).

4.6 This, combined with the trend of insurers taking stakes in intermediaries and intermediaries acting on behalf of the insurer, has contributed to a blurring of the distinction between insurers and intermediaries.

4.7 Another relevant feature is the increased use of delegated authorities. The intermediary may accept risks on the insurer’s behalf (known as a ‘binding
authority’), or may just take on simple administrative functions for the insurer. These arrangements are sometimes formalised through the use of Managing General Agents (MGAs). This is where an insurance intermediary is authorised by an insurer to transact insurance business as its agent. The MGA may have delegated authority to bind the insurer, issue policies, adjust claims and/or provide administrative support. These arrangements are typically associated with the use of profit-based contingent commission, as they seek to align the intermediaries’ incentives with that of the insurer.

4.8 All of this suggests that the risk of conflicts of interest is almost certain to become more pronounced – particularly in business conducted with middle-sized commercial customers, a sector where intermediaries are likely to focus more in the future.

Clarity

4.9 As we have seen, CRA’s research highlighted concerns about the clarity and completeness of the information commercial customers receive about their intermediary. Without this, their ability to understand what they are paying for and to judge the value for money they are getting by making meaningful comparisons across the market is significantly compromised. This, in turn, can adversely affect their ability to make informed decisions and thus their ability to inject greater competitive discipline into the intermediary market.

4.10 The position on remuneration is reasonably clear where the intermediary receives fees from the customer or standard commissions from the insurer. But it appears to be much less clear where contingent commissions or other forms of remuneration are involved – for example, premium finance payments and payments relating to work transfer agreements. We discuss these further below.

Contingent commissions

4.11 A particular concern here is the disclosure of contingent commissions – and this is essentially about a failure to comply properly with the existing requirements.

4.12 Our rules require that disclosure must be in cash terms (estimated, if necessary), but to the extent that this is not possible, the firm must give the basis for calculation. This reflects the requirement under the law of agency that customers should be made aware of the nature and extent of any commission payment.

4.13 However, CRA’s research found that, where an intermediary is earning contingent commissions, the extent of this remuneration is not always fully transparent. Anecdotal evidence suggests that many intermediaries are merely indicating that they may be paid additional commission on a profit or volume-related basis, but are not giving any details of how this will be calculated. This is not sufficient.

4.14 Contingent commissions are, by definition, dependent on a future event. They are typically paid across a book of business rather than for individual contracts. So we accept that a precise figure may not be available at the point of sale. But the firm should give the customer a clear indication of the likely amount payable.
4.15 Our main concern here is that a lack of transparency over contingent commissions gives customers a misleading picture of the cost of mediation. It also opens up the possibility of arbitrage, in that it enables an unscrupulous intermediary to disguise the true cost of his services. The net consequence of this could be that remuneration structures are inefficient and commission rates unduly inflated. So we believe that full transparency in relation to this type of remuneration arrangement is essential.

4.16 This is, in fact, an issue which we have previously flagged in a Dear CEO letter and we will be looking closely at firms’ current practices as part of our thematic work. We also raise a question below about whether, in the interests of comparability, we should prescribe – or give guidance – on how this should be done and we also explain our concerns about the potential conflicts of interest to which these particular arrangements give rise.

Other forms of remuneration

4.17 A further concern relates to other forms of remuneration which some firms believe fall outside the definition of commission. For example, some firms have argued that the remuneration they receive in connection with “work-transfer” agreements does not need to be disclosed as it relates to work carried out on behalf of the insurer, not the customer. (These “work transfer” agreements have a range of different names, such as Market Service Agreements (MSAs) and Placement Service Agreements (PSAs).)

4.18 Some market participants have voiced concern that firms could use these agreements to avoid having to disclose payments to their customers. So this is another instance where we believe customers may not be receiving complete information. (We are also concerned that these may give rise to conflicts of interest, by providing an incentive for the intermediary to favour those insurers with whom it has an MSA.)

4.19 Given the increased blurring of the roles of insurers and intermediaries – and the relevance this has in terms of fair and efficient markets – we question how far these arrangements fall outside our disclosure requirements.

4.20 There is also some concern that where intermediaries are being paid both fees and commission, they are not automatically disclosing commission, as they are required to do. Again, it is essential that customers are given a clear picture of what they are paying – and that conflicts are properly managed.

Commission throughout the chain

4.21 Another source of concern about the clarity of commission information relates to the lack of transparency about commission received elsewhere in the distribution chain.

4.22 Under our existing rules (which, as we have seen, already extend the obligations under common law) only customer-facing intermediaries are required to disclose to commercial customers, on request, the commission that they (and their associates) receive. This means that commission earned by intermediaries elsewhere in the chain is not disclosed.

---

15 Dear CEO letter, Commission disclosure for commercial customers.
http://www.fsa.gov.uk/pubs/ceo/commission_disclosure.pdf

16 Only remuneration in relation to an insurance mediation activity falls within the definition of commission used in the Handbook.
distribution chain (e.g., by wholesale brokers) does not have to be disclosed—and customers may not even be aware of these intermediaries’ existence. (While CRA found that long chains were less common in domestic (regional) business—some specialist risks commonly involve chains.)

4.23 This is yet another example of where customers are receiving only partial information about the full cost of mediation.

4.24 If commercial customers are unaware of the involvement (and cost) of other intermediaries involved in placing their business, this may make them less likely to look for—and thus encourage the development of—cheaper, more efficient distribution models. It could also increase the length of chains. We therefore think the lack of transparency of commissions throughout the chain could lead to market inefficiency.

4.25 We believe there should be full transparency to commercial customers of the total amount of commission earned by intermediaries throughout the chain. We do not, however, believe that it is necessary for the customer to receive a breakdown of how this is split between the different intermediaries within the chain.

4.26 Nor do we share the view put forward by some in the industry that insurers should also have access to information about the way commission is allocated between the intermediaries within the chain. As CRA’s report explained, there are convincing reasons why such a practice would, in fact, be anti-competitive, particularly given the increasing levels of vertical integration in this market.

**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 throughout the chain.

**Breadth of search**

4.27 Another area of concern that CRA highlighted is the general lack of understanding among commercial customers about the extent to which their intermediary—or an intermediary elsewhere in the chain—searches the market. We recognise that the extent of search is by no means the only service that an intermediary provides, but we see this as fundamental.

4.28 Our existing rules in ICOBS 4.1.6R already require an intermediary to disclose information about the extent to which it searches the market and its relationship with the insurers for whom it arranges business.

4.29 This includes information on whether the intermediary sells on the basis of a ‘fair analysis’ of the market; sells the products of only one insurer; or selects products from a limited number of insurers, and if so, whether it is contractually obliged to sell from those insurers alone. An intermediary that sells across a limited range is
required (by ICOBS 4.1.6 R (2)) to inform the customer that he has the right to request the name of each insurer with which the intermediary may (and does) conduct business.

4.30 CRA’s research found that between 75%-95% of customers assumed their intermediary provided advice on the basis of fair analysis. But, in fact, only 60% of intermediaries conducted their business on this basis and 40% used a limited number of insurers.

4.31 A related concern is the lack of transparency about the nature and extent of the search where a chain of intermediaries is involved. For some risks, a customer-facing intermediary may delegate the task of placing the risk to a wholesale intermediary, but the customer may not be aware of the basis on which this is being done.

4.32 We see disclosure of the extent of the search an intermediary provides as a key element in enabling the customer to judge the value of his services. So we are concerned about the lack of clarity in this area and need to consider whether there is anything further we can do to improve the position.

**Outcome 2**

Commercial customers should have clear information about the services an intermediary provides, including the breadth of search he undertakes.

**Status of intermediary / conflicts of interest**

4.33 CRA also drew attention to wider concerns about a lack of understanding of the intermediary’s status – ie the capacity in which he is acting.

4.34 A key concern here is the lack of clarity about whether the intermediary is acting for the customer, for the insurer or, in some cases, for both. This raises questions about how the intermediary manages any conflicts of interest to which his status gives rise and how far the commission, for which the customer is ultimately paying relates to the work the intermediary is doing for him.

4.35 This is an issue which is gaining particular importance in a market where, as we have already observed, the distinction between insurers and intermediaries is becoming less clear.

4.36 We believe that certain business models and remuneration arrangements exacerbate the inherent conflicts that stem from an intermediary’s dual role as adviser to his clients and distributor to insurers, and that these are contributing to the opacity in this market.

4.37 This raises concerns about the effectiveness of our current requirements. In particular, it raises a question about the use of the term ‘broker’, which generally carries with it an assumption that the intermediary concerned is acting solely in the interests of the customer.
4.38 The use of this term was previously subject to regulation under the Insurance Brokers Registration Act 1977. But this was repealed around the time that FSMA came into force, and there are currently no restrictions on who can use this description.

4.39 Increasingly, however, it seems that intermediaries have divided loyalties, of which customers may not always be aware. Examples include the increasing prevalence of delegated authorities, which result in some of the insurer’s functions being carried out by an insurance intermediary.

4.40 Our current status disclosure requirements (see ICOBS 4.1.1R) do not specifically require insurance intermediaries to state if and when they are acting on behalf of the insured or a third party. But firms are required to disclose any conflicts of interest that might arise.

4.41 As we have already mentioned, insurance intermediaries are also subject to certain requirements to disclose the nature of the service they provide and their relationship with the insurers with which they do business.

4.42 Otherwise, we rely on Principle 8, which requires a firm to manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.

**Outcome 3**

Commercial customers should have clear information about the capacity in which an intermediary is acting – ie 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.

**Consistency/comparability**

4.43 Another area of concern is the lack of consistency – and therefore comparability – in the way that commission disclosures are made. This may even go some way towards explaining the apparent lack of interest among commercial customers in obtaining and using this information.

4.44 One of the main purposes of commission disclosure, in our view, is to enable the customer to gauge the value of the service which an intermediary is providing – and to use this as a benchmark for comparing and assessing the cost and services of other intermediaries and alternative ways of placing their risk.

4.45 This provides the customer with the opportunity to look for the best deal. We recognise that some customers – particularly those with specialist, bespoke risks or long-established relationships with trusted advisers – may, in practice, have a limited appetite for shopping around themselves. But we believe that the fact that they could do so if they wished is, nevertheless, an important factor in creating an efficient market.
4.46 Our concerns about comparability are most acute in relation to the disclosure of contingent commissions. The level of remuneration derived from these arrangements is uncertain at the point of sale, so the way firms give customers an indication of their likely extent is to some extent subjective and can vary significantly. This makes comparisons between intermediaries difficult. Ultimately this lack of comparability weakens competition and impedes efficiency.

4.47 We therefore believe that contingent commissions should be calculated in cash terms and on a standardised basis. This could be done, for example, on the basis of the maximum amount the intermediary stands to make if there were no claims. Or it could be based on a historical average of what the intermediary has actually received in, say, the past, three years. While the former may offer a more objective basis for comparison, the latter may be a more meaningful figure for customers, although allowances would have to be made for new areas of business and for periods which were atypical.

4.48 We will also want to consider whether there is any merit in standardising the format of these disclosures, although we recognise that this is something we have moved away from in other areas recently.

4.49 There may also be a case for standardising or defining the use of certain terms, such as ‘binding authorities’, ‘delegated authorities’, ‘work transfer’ arrangements, ‘workshare agreements’ etc to aid comparability and customer understanding.

4.50 The difficulty in making comparisons between intermediaries is exacerbated further by the lack of clarity about the services different intermediaries offer, which we have already noted. This means that customers are not necessarily comparing like with like.

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).

Accessibility

4.51 The key issue for us here is whether commercial customers need to receive commission information automatically – or whether it is enough for us simply to ensure that they have access to clear and comparable information and then continue to rely on customers to ask firms for it if they want it.

4.52 We continue to believe that commission information is potentially of significant value to commercial customers in helping them to make informed and appropriate decisions. Provided that the information is clear, complete and comparable, it can help them to understand the cost of the services their intermediary provides and compare these with the cost of placing their risk through other intermediaries or alternative channels.

4.53 Even where customers do not use commission information to assess the value of the services provided by their intermediary, we believe that the availability of this
information is an important part of market efficiency. This exerts a competitive
discipline on intermediaries’ costs and acts as a potential check on conflicts of interest.

4.54 However, we know that very few commercial customers currently exercise their right
to obtain this information if they do not receive it automatically. So this concerns us.
(CRA’s compliance cost survey results indicated that, setting aside firms who
voluntarily disclose automatically, 75% of intermediaries had never had a request
for commission information.)

4.55 We are not entirely convinced by the reason that we and CRA have frequently been
given for this – that commercial customers are only interested in the bottom line – ie the
overall price of insuring their risk. CRA’s research suggests that the picture is, in fact,
rather more complex than this.

4.56 CRA’s survey work showed that a third of commercial customers are, in fact, unaware
that they have the right to request this information. This is in spite of the welcome
initiative introduced almost two years ago by trade associations, such as LMBC and
BIBA17. This resulted in many intermediaries reminding customers in their Terms of
Business Agreements (ToBAs) of their right to ask for commission information.

4.57 CRA also found that customers who do not ask for commission information
commonly underestimate how much their intermediary is paid. On average, these
customers estimated that intermediaries received 10% of the total premium, but the
typical rate is closer to 20%. Our concern here is that many customers may be
choosing not to ask for this information because they mistakenly assume they know
the answer and/or believe that the commission payable has a relatively small impact
on the total cost of their insurance.

4.58 The problems arising from lack of access to commission information were found
to be most acute within the segment of middle-sized customers, who account for
around half the market (measured as a proportion of gross premiums). These
customers are most likely to use an intermediary that charges commission,
including contingent commissions.

4.59 We believe that more needs to be done to understand why commercial customers are
not currently requesting this information and to ensure that, at the very least, they
are aware of their rights and appreciate the value of this information.

Outcome 6
Commercial customers should be made aware of their right to commission information and
helped to appreciate the value of using it.

4.60 In the next chapter, we invite views on potential solutions to the concerns described
in this chapter, including possible amendments to our rules and the scope for
industry solutions.
5 Potential solutions

5.1 In this chapter, we consider possible solutions to the concerns outlined in Chapter 4. In doing so, we seek to take account of current developments in this market and likely future trends.

5.2 We focus, in particular, on how to make the information commercial customers receive about an intermediary’s commission and the services he provides clearer and easier to compare. We also consider how best to achieve clarity about the status of the intermediary and ensure that any conflicts of interest are properly disclosed and managed. However, final decisions will be informed by the responses to this paper and the results of our thematic work and customer-focused research.

5.3 The possible solutions considered in this chapter are not necessarily mutually exclusive – various permutations are possible. Most could be introduced either via regulatory means or through industry agreement/codes.

5.4 In Annex 3, we provide a high-level cost-benefit analysis (CBA) of the possible regulatory options to indicate the kind of costs that we think these might involve. However, if we decide to pursue any of these, we will carry out a more detailed CBA and consult on our proposals.

5.5 We would prefer market-led, rather than rules-based, solutions wherever possible. This has already proved successful in areas such as contract certainty, where the market developed and implemented measures to ensure timely agreement of the terms of insurance contracts and the provision of these details to customers.

5.6 However, market-led solutions clearly work best where interests and incentives are closely aligned across the market. In the case of transparency of remuneration, we have observed a significant polarisation of opinion, which suggests that achieving consensus on this issue may be difficult. But we continue to explore the scope for an industry solution and there have been some encouraging developments, which we describe towards the end of this chapter.
What are we trying to achieve?

5.7 In the previous chapter, we identified a number of concerns that we believe need to be addressed.

5.8 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 additional work we are carrying out, are as follows:

**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 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 – ie 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).

**Outcome 6:** Commercial customers should be made aware of their right to commission information and helped to appreciate the value of using it.

5.9 We examine options for achieving these outcomes in the rest of this chapter.

Legal and policy considerations

5.10 Any consideration of potential rules-based solutions must take account of the scope of our regulatory powers and our legal duty to have regard to the competitiveness of the UK financial services market. In particular, they must be compatible with the applicable European Directives.18

5.11 We also have to bear in mind our general preference for principles-based regulation rather than prescription – and for avoiding ‘gold-plating’ (ie being super-equivalent to) directives wherever possible.
5.12 This inevitably places constraints on the extent to which we can protect commercial customers, especially where transactions involve chains which span UK and European boundaries and involve participants (insurer/wholesale broker/retail broker/customer/risk) that may well be located in different parts of the world.

5.13 The existing ICOBS requirement to disclose commission to commercial customers on request applies only to UK-based intermediaries who are in direct contact with the customer (ie it does not apply to all intermediaries in the chain). So most international customers in the London market are currently not covered (because they are usually dealing with UK-based intermediaries through non-UK based intermediaries).

5.14 **Territorial scope:** In practice, we could not impose requirements directly on non-UK intermediaries that are not authorised by the FSA, and there may be limits on our ability to impose requirements on insurers in relation to risks in other EEA member states and on intermediaries that passport into the UK under a European directive.

5.15 **Large risks:** ICOBS does not currently apply to intermediaries in relation to contracts of large risk (wherever the risk is located). However, the large risks definition captures many middle-segment customers. So we envisage that we would need to remove the large risk exemption in respect of any rules (or guidance) so that these would apply to business done with commercial customers, irrespective of their size.

5.16 **Reinsurance/facultative reinsurance:** ICOBS does not currently apply to reinsurance contracts and we believe that these should remain outside the scope of any regulatory solution. These contracts are covered under our high-level Principles (in particular, Principles 1 and 8) and we believe that the risk of arbitrage is relatively small.

5.17 So the scope of any potential regulatory requirements is something to which we would need to give careful thought.

**Potential approaches**

5.18 There are, in broad terms, three – potentially cumulative – approaches that we could adopt:

*(i) Improve current regime through more rigorous supervision and enforcement of our existing rules and principles, plus guidance and a customer education initiative.*

5.19 As we have noted, a number of the issues which we have identified are already subject to our rules – eg the requirement to disclose the extent of contingent commissions and the management of conflicts of interest. So it would be possible to...

---

19 This reflects the existence of an exemption in the Insurance Mediation Directive, so its removal would make the ICOBS rules super-equivalent to the directive in that respect.
cover some of this ground by supervisory means – possibly supplemented by further guidance or a further ‘Dear CEO’ letter on what is expected. This could be supported by additional reporting requirements on firms to inform us of any remuneration arrangements and business models likely to create conflicts of interest and the processes firms have in place to deal with these. This would facilitate more targeted supervision.

5.20 At the same time, we could seek to improve the accessibility of commission information through a targeted FSA education campaign (possibly with industry involvement)\(^{20}\) aimed at increasing customers’ understanding of their rights and the value of requesting this information. We believe this could help to make commission information an effective tool in driving competition among intermediaries. So we plan to take forward this initiative irrespective of any other actions we may decide to take.

5.21 However, the approach outlined above would only provide a partial solution. It could not deliver the outcomes we want to achieve where we believe new requirements on firms are needed, such as disclosure of commission paid throughout the chain or greater standardisation in the calculation of contingent commissions, the use of terminology and possibly the format of disclosures. This would require either a regulatory solution or an industry-wide agreement.

(ii) Enhanced ‘on-request’ regime

5.22 An alternative approach would be to seek to achieve the outcomes described above within the context of the current ‘on-request’ regime.

5.23 This would involve introducing new requirements designed to improve the transparency and comparability of disclosure, but the commission disclosure requirements would apply only where commercial customers requested disclosure or received it voluntarily.

5.24 As far as accessibility is concerned, we would rely on the effectiveness of our customer education initiative to encourage commercial customers to request and use this information.

5.25 This could perhaps be reinforced by a requirement on intermediaries to remind customers – possibly orally – of their right to receive this information at the point of sale. We recognise that some trade associations have already made commendable efforts to do this by requiring their members to include a reminder in their Terms of Business Agreements (ToBAs). But CRA found that more than one-third of customers are still unaware of their right to ask. So this may call for a more comprehensive / formal solution. We know, from research, that retail customers respond better to oral disclosures. But we would need to test whether the same is true of commercial customers and propose to do so as part of the customer research that we are undertaking.

5.26 As under option (i), our concerns about conflicts of interest could be addressed through increased supervision and guidance.

\(^{20}\) This could involve an FSA leaflet along similar lines to that already produced by the Association of Insurance Risk Managers (AIRMIC).
5.27 In order to secure our objective of achieving better comparability, we believe that any enhanced commission disclosure requirements would need to apply not only to disclosures made ‘on request’, but also to disclosures made by firms on a voluntary basis. However, there is, of course, a risk that this might deter firms from continuing to disclose voluntarily.

(iii) **Mandatory commission disclosure**

5.28 The third approach would be to introduce the same measures as under the previous option but to require commission disclosure to be made automatically, rather than on request.

5.29 This is, of course, the most comprehensive option, in terms of ensuring that everyone has access to clear and comparable commission information, but it is also the most prescriptive and involves significant costs. CRA concluded that this measure was not, by itself, a proportionate solution as the cost of mandating commission disclosure outweighed the benefits because, *in the absence of other measures*, only a limited number of customers were likely to benefit from it.

5.30 However, as we have noted, CRA’s work has highlighted a number of wider transparency and market efficiency issues that we also need to mitigate. So it is possible that this option (combined with other measures described in this paper, such as improving the comparability of disclosures) could address the wider issues as well. This in turn might change the cost-benefit equation and offer the most effective way of achieving our wider objectives.

5.31 As CRA’s report indicates, a mandatory commission disclosure regime could take several different forms. But CRA concluded, in light of the need to avoid unintended consequences (including the scope for arbitrage) that the optimum model would be Scenario 3(a), as described in its report.21

5.32 To demonstrate what such a requirement might look like, we have included, for **illustrative purposes only**, a set of draft rules (in Annex 2). (These could be adapted, if preferred, to give effect to an enhanced ‘on request’ regime.) We would emphasise, however, that there is no question of our making these rules without full consultation and cost-benefit analysis.

5.33 The illustrative draft rules in Annex 2 would require all customer-facing, UK–based intermediaries to provide their commercial customers22 automatically and before conclusion of the contract with information – in cash terms – about the total23 commission payable throughout the whole chain.

5.34 Where precise amounts could not be given in cash terms (eg for contingent commissions), the draft rules would require firms to provide an estimate based on the maximum sum they might earn (ie assuming no claims). However, as noted in

---

21 See Footnote 12.
22 Any such requirement would not bite on wholesale brokers, as they do not have a customer relationship with the commercial customer at the end of the chain. However, it might be necessary to place them under an obligation to facilitate the provision of this information where necessary.
23 There is no requirement to disclose how total remuneration is shared between intermediaries participating in the contract.
the previous chapter, alternative methods (eg actual figures over a specified period) might be considered preferable.

5.35 The draft rules place the obligation on the insurer to ensure that the total commission payable throughout the chain is provided to the commercial customer, but allow responsibility for actual disclosure of the information to be delegated to the customer-facing intermediary. Wholesale intermediaries might also need to facilitate this process where there is a long chain. So the draft rules indicate that the customer-facing intermediary would discharge its commission disclosure obligation provided that it used its best endeavours to disclose the total remuneration to the customer.

5.36 An alternative would be to require the insurer to provide the information as part of the policy documentation after the point of sale. Although this approach is superficially appealing for its simplicity and potentially lower cost compared with pre-sale disclosure, customers would only be able to use this information to inform future purchases/renewal of insurances – so benefits might be lower.

5.37 The illustrative draft rules contain a provision indicating that, to the extent that the insurer outsources services to the intermediary, it need not include the reasonable commercial value of those services in respect of the contract. In other words, it provides the option of disclosing total commission net of, for example, payments for work transfer under managing general agency arrangements or coverholding arrangements. However, the illustrative draft rules make it clear that a firm which deducted work transfer payments would be expected to be able to show how the amount of the deduction related to the value of the service it provided.

5.38 The impact of these rules (whether applied in a mandatory or an ‘on request’ context) would, of course, also depend on the scope of their application. This is a potentially complex issue, especially in view of the application of the current ICOBS rules and the fact that different participants in the chain could be situated in different locations.

5.39 In the remainder of this chapter, we consider some further options which are capable of being delivered under one, or more, of the approaches outlined above.

Making information easier to compare

5.40 One way of achieving greater standardisation in the disclosure of commission information would be to establish a common set of definitions or principles for describing certain types of remuneration arrangements or services, which are currently described in a number of different ways (eg binding authorities / MGAs etc).

5.41 We could, if we deemed it necessary, go further and develop standardised commission disclosure templates or pro-formas to ensure that commission information and even information about the nature of the relationship intermediaries have with their customers and third parties is provided in a consistent manner.

5.42 These are ideas that we will want to test as part of the customer research which we will be commissioning in the coming weeks. This will enable us to assess how best
to engage commercial customers and what information they find most useful and in what format.

_Improving the way firms mitigate conflicts of interest_

5.43 Our general approach to conflict management is that firms should seek, in the first instance, to manage the conflict within the structure of their organisation. Where this is not possible, disclosure may act as an effective mitigant. But where this is not the case, the firm’s only options may be either to choose not to accept the business or to remove the source of the conflict itself.

5.44 Some European countries have banned commission and introduced instead a system of mandatory ‘net quoting’. This was done to mitigate risk of conflicts of interest and enhance price transparency in relation to insurance mediation services.

5.45 We are not suggesting that we should follow suit. However, arrangements such as contingent commissions (including those associated with binding authorities) seek to align the intermediary’s incentives with the insurer’s, rather than the customer’s. Firms will therefore need to demonstrate that any conflicts have been adequately managed or disclosed to ensure that the customer is properly protected.

5.46 Our previous thematic work identified shortcomings in firms’ conflict management arrangements. As part of our current piece of thematic supervision we will look specifically at conflicts of interest that arise from remuneration and other arrangements in the commercial insurance market. This work will consider both the nature of the conflicts firms face and how effectively firms currently manage these conflicts of interest. As such, it will help us to assess the effectiveness of our existing requirements.

5.47 Possible options for resolving these points include revisiting our existing status disclosure requirements (ICOB 4.1.2R) to include clearer, more explicit disclosure about who the intermediary acts for and in what capacity. Another option could be to extend the requirements that apply to ‘common platform’ firms in SYSC 10.1.8R to include general insurance business.

5.48 We will decide whether improvements to our current requirements are necessary in the light of the results of our thematic work and responses to this paper.

---

24 A common platform firm is a term we have given to firms subject to either or both the Markets in Financial Instruments Directive and the Capital Requirements Directive.
Improving understanding of the extent of search carried out by an intermediary

5.49 As we explained in the previous chapter, we see disclosure of the type and extent of the search undertaken by the intermediary as a key element in enabling the customer to judge the value of the services an intermediary offers.

5.50 Our existing rules in ICOBS 4.1.6R already require information about the extent of search undertaken by an intermediary and its relationship with its insurers to be disclosed. This includes information on whether the intermediary sells on the basis of fair analysis or from a limited number of insurers, and if so, whether he is contractually obliged to sell from those insurers alone. However, CRA’s research shows that customers remain unclear about the services they receive. So we need to consider if this could be made clearer.

5.51 We could, for example, require intermediaries to inform their commercial customers of the number of quotes they obtain or their criteria for selecting any panels and the frequency with which they review these. And where an intermediary uses other intermediaries to place the insurance, rather than doing so directly, we could require it to disclose this fact.

5.52 We could also place conditions on the use of the term ‘broker’. These might include, for example, a requirement that he operates on a ‘fair analysis basis’ and is not a party to any arrangements (such as contingent commissions).

5.53 We plan to consider the relative merits of these options as part of our consumer research work and would also welcome respondents’ views.

Scope for an industry solution?

5.54 Finally, as noted above, we have not ruled out the possibility of an industry solution to some or all of our concerns, although we recognise that views on these issues – particularly those relating to commission disclosure – are polarised.

5.55 We have had detailed and regular discussions with all of the relevant trade associations throughout last year and since the publication of CRA’s report. We are grateful for their constructive engagement in these issues and are encouraged by recent developments on this front.

5.56 In January this year, BIBA published some helpful new guidance for their members aimed at addressing some of the key areas of concern, especially about the way contingent commissions are disclosed. This follows two earlier pieces of guidance on this topic. Copies of these are available from BIBA.²⁵

5.57 In addition, the LMBC has now produced some draft industry guidelines. These guidelines focus on clarification of the existing commission disclosure requirements, conflicts management and the capacity in which an intermediary is acting.
5.58 LMBC believes this could provide a basis for a market-wide solution. However, a key issue will be how far these draft guidelines are capable of attracting sufficient industry ‘buy in’. Anyone interested in obtaining a copy of LMBC’s draft guidelines should contact LMBC direct.26

Next steps

5.59 We invite comments on this paper by 25 June 2008 – in particular, on the questions in Annex 1. Feedback from this DP and the results of our additional work will help to inform our decision on whether to make changes to our rules or supervisory practices. We will formally consult in the fourth quarter of 2008 if we decide that rule-changes are necessary.
Q1  i) Do you have any comments on CRA’s market-failure and cost-benefit analysis?  
    ii) Do the wider market efficiency issues highlighted in this paper affect the cost  
        benefit case for regulatory intervention, and how?  
Q2  Do you agree that customers need to know the total remuneration earned by other  
    intermediaries in the chain? If so, do you have any views on the logistics of  
    providing the required commission information?  
Q3  Do you agree that contingent commissions should be disclosed in cash terms and on  
    a comparable basis? If so, what do you consider to be the best way of doing this?  
Q4  Do you agree that intermediaries should provide information on the capacity in  
    which they are acting – ie as agent for the customer or the insurer or both? How  
    should this be disclosed?  
Q5  We would welcome views on whether any particular arrangements / business  
    structures give rise to unmanageable conflicts of interest?  
Q6  Should we place any restrictions on what those describing themselves as ‘brokers’  
    can do?  
Q7  Do you have any views on how we might best improve customers’ understanding of  
    the breadth of search undertaken by their intermediary?  
Q8  To what extent do you think we could rely on a customer education initiative to  
    help commercial customers understand the value of information about commission  
    and services?  
Q9  We have made several suggestions in the paper about how to improve the  
    comparability of information on both remuneration and services. Which of these do  
    you think is likely to be most effective? Are there any other approaches you believe  
    we should consider?  
Q10 We would welcome comments on the relative merits – or drawbacks – of the three  
    broad approaches outlined in Chapter 5. What other approaches (or permutations),  
    if any, should we consider?  
Q11 What are your views on the practicability of the options we set out and their  
    implications for the competitiveness of the UK market?  
Q12 Are there any other issues that you think we should consider?
Illustrative Draft Rules
ANNEX 2

ILLUSTRATIVE DRAFT RULES

[NB These rules are included for purely illustrative purposes. They will not be made without further consultation.]

4.4 Commission disclosure for commercial customers

Application

4.4.1 R This applies to:

(1) an insurance undertaking; and

(2) an intermediary (whether or not an insurance intermediary) which carries on insurance mediation activities.

The commission disclosure obligation

4.4.2 R Before a contract is effected, each insurance undertaking with which, or intermediary through which, a commercial customer proposes to effect a contract of general insurance, must ensure that the total remuneration that all intermediaries (and their associates) will receive if the contract is effected or carried out is disclosed to the customer.

4.4.3 R The intermediary which deals directly with the commercial customer discharges its commission disclosure obligation if it uses its best endeavours to disclose the total remuneration to that customer.

Total remuneration

4.4.4 R In this section, total remuneration:

(1) includes any payment from the insurance undertaking;

(2) includes any payment from a third party; and

(3) the value of any arrangement for a future payment from either of them; but

(4) does not include any fees disclosed under ICOBS 4.3.

4.4.5 G An arrangement for a future payment includes, for example, a payment of commission the amount of which is contingent on the volume or performance of the insurance business of which the contract is a part.

4.4.6 G A payment from a third party includes a payment by a lender as commission for arranging, or introducing the customer for, premium finance.

Complying with the commission disclosure obligation
4.4.7 R If there is a chain of intermediaries between the insurance undertaking and the customer, or multiple insurance undertakings participating on the contract, a single disclosure of the required information to the customer discharges the commission disclosure obligations of all, in respect of that contract.

4.4.8 R The commission disclosure obligation does not require the disclosure of how total remuneration is shared between intermediaries participating on the contract.

4.4.9 R (1) The disclosure of the amount of total remuneration under 4.4.2 R must include the remuneration for the intermediary's insurance mediation activities or the promotion of those activities.

(2) To the extent that the insurance undertaking outsources services to the intermediary, it need not include the reasonable commercial value of those services in respect of the contract.

4.4.10 G The effect of 4.4.9R is to provide the option of disclosing total remuneration net of, for example, payments for work transfer under managing general agency arrangements or coverholding arrangements. The expectation is that a firm that deducts work transfer payments will be able to show how the amount of the deduction relates to the value of the service it provided.

4.4.11 R Total remuneration must be disclosed in cash terms, estimating the maximum expected value of future payments.

4.4.1 R (1) An insurance intermediary must, on a commercial customer’s request, promptly disclose the commission that it and any associate receives in connection with a policy. (2) Disclosure must be in cash terms (estimated, if necessary) and in writing or another durable medium. To the extent this is not possible, the firm must give the basis for calculation.

4.4.2 G An insurance intermediary should include all forms of remuneration from any arrangements it may have. This includes arrangements for sharing profits, for payments relating to the volume of sales, and for payments from premium finance companies in connection with arranging finance.

4.4.12 G (1) The commission disclosure rule obligation is additional to the general law on the fiduciary obligations of an agent in that it applies whether or not the insurance intermediary is an agent of the commercial customer.

(2) In relation to contracts of insurance, the essence of these fiduciary obligations is generally a duty to account to the agent’s principal. But where a customer employs an insurance intermediary by way of business and does not remunerate him, and where it is usual for the firm to be remunerated by way of commission paid by the insurer out of premium payable by the customer, then there is no duty to account but if the customer asks what the firm’s remuneration is, it must tell him.
High-level cost-benefit analysis (CBA)

Last year, CRA considered the case for mandating disclosure of commission. This discussion paper broadens the debate to consider wider transparency and market efficiency issues. We are also interested in how the various options we consider interact to affect the overall outcome.

In its report on commercial insurance commission disclosure, CRA found little evidence of market failure in two segments of the UK commercial insurance market: the micro-enterprises and large corporate customers. However, CRA identified a “middle segment” of commercial clients – with turnover between £0.5m and £100m – who are at risk of suffering detriment resulting from asymmetric information problems. CRA, nevertheless concluded that the benefits of a mandatory disclosure regime alone would exceed the costs of the regime.

This “middle segment” of commercial clients accounts for £9bn Gross Written Premium per year, which is about 50% of the UK commercial insurance market. The expenditure on insurance for these firms varies from 0.4% of turnover for the larger end clients (ie with £20m-100m turnover) to 0.8% of turnover for the smaller end clients (ie with £0.5-5m turnover). This relatively low level of commercial clients’ spending on insurance (compared with other business expenditures) could contribute to their low level of engagement in the purchasing process: CRA found that less than 20% of clients act on commission information provided to them. In comparison, an average household spends about £1,000 a year on motor, building and content insurance, which accounts for 5% of an average household after-tax income of around £20,000, and personal lines insurance is competitive: consumers typically obtain 3-4 quotes for motor insurance. What is important for clients are the costs of negotiation and search, weighed against the benefits of seeking a better deal.

28 Based on AA insurance premium index: http://www.theaa.com/services/insuranceandfinance/insuranceindex/ motor insurance average: £629.04; building insurance: £218.60 and content insurance: £150.57.
We present below a preliminary and high-level cost benefit analysis of the policy options, which are not necessarily mutually exclusive. Respondents views on the wider transparency and market efficiency issues will help us to deliver a fuller CBA of any firm proposals that we eventually make.

**Costs**

- The first policy option is more rigorous supervision and enforcement of existing rules and principles, plus guidance and a customer education initiative.

There are incremental costs associated with additional supervision and enforcement (compared with the current actual level of costs), and incremental compliance costs (assuming that more rigorous supervision and enforcement lead to more/better compliance). The costs would depend on the number of disclosures requested.

The direct cost of any education campaign would depend on its nature and scale. Additional disclosure requests arising from the education campaign would also give rise to costs.

- The second policy option is enhancing the current “on-request” regime through an education campaign and requiring intermediaries to remind clients orally of their right to request the information. This is supported by status and service disclosure as considered below.

The costs for this policy option include (limited) costs of reminding clients’ of their right to information at the point-of-sale itself; the cost of a specific education campaign, and the additional costs associated with increased disclosure. The costs associated with increased disclosure (as a direct result of reminder and/or education campaign) will depend on how many (additional) clients ask for the information, what level of disclosure is required and whether or when system changes are required.

CRA’s CBA of mandatory commission disclosure is an indication of the potential costs involved (that is, if every client decides to exercise the right to information following the reminder). The costs could be lower than the mandatory commercial disclosure analysed by CRA, as some clients may not exercise their right even after the reminder and education campaign. On the other hand, under the enhanced ‘on-request’ regime there is uncertainty associated with whether and when to implement system changes: should a firm decide not to make systems changes from the outset and then be faced by higher than expected requests, it could face high ad hoc handling costs before being obliged to incur systems costs. So its overall costs could be higher than those estimated by CRA.

- The third policy option is mandating automatic commission disclosure.

The costs for this policy option include the compliance costs, estimated by CRA at approximately £87m of one-off costs for insurers and intermediaries and £34m of ongoing costs. This included an element of standardisation. CRA finds that, while these costs fall roughly evenly between insurers and intermediaries, they do not fall evenly across different intermediaries: large international firms have a relatively low

---

cost of complying as they are already disclosing their commission; smaller intermediaries will face proportionally larger compliance costs.

- In addition, the DP considers standardisation of information (to facilitate comparison of different firms’ costs and service), better disclosure of the status of the intermediary, and better disclosure of the service offered.

Potential costs of standardisation include the cost of agreeing a standard set of definitions and the cost of intermediaries complying with the standard set, as well as the cost of any reduced variety in the market. There should be little incremental cost of disclosing any relationship (eg binding authority) that the intermediary has with the recommended insurer. Costs of disclosing services provided clearly depend on the specific requirements. In addition, these changes could lead to increased overall search costs should clients decide to shop around more. (The costs of increased shopping around may be more than offset by increased benefits.)

**Benefits**

These policy options would improve access to information, and clarity and comparability of information, which could result in clients being more engaged in the purchasing process. In particular, the disclosure of the relationship between the intermediary and the specific insurer whose product the intermediary is recommending could offer clients a better understanding of the incentives of the intermediary (eg a client may seek another quote from a different intermediary after learning that the first intermediary has a binding authority with the insurer whose policy the intermediary is recommending). The main benefit from these policy options therefore could be enhanced competition among intermediaries, which could lead to more efficient levels of commissions and premiums. Clarity of information on services provided by intermediaries and their corresponding costs could also lead to a more efficient level of consumption of intermediary services.

The extent of benefits will depend not only on how many additional clients exercise their right to information after the reminder and/or education campaign, but also how many clients act on any information provided (whether through “on request” or automatic disclosure). This, in turn, could vary significantly across the client segments:

- For large sophisticated corporate clients, who typically pay fees, employ risk managers and use large international intermediaries who already disclose their remuneration, CRA did not identify a market failure associated with commission transparency, suggesting the incremental benefits of the proposed policy options are likely to be limited. However, we now wish to consider fully the potential benefits for these clients and other segments from standardisation, and from better disclosure of status and service.

- For the smallest commercial clients, given the strong growth of the direct channel and the withdrawal of intermediaries serving this segment, CRA saw no market failure related to commission transparency, implying the benefits are also likely to be limited.

---

For the “middle segment” – the clients that are most at risk of suffering detriment from non-disclosure of commission – the extent of the benefits will vary between:

- larger or more sophisticated firms in the “middle segment”, who are more like large corporate clients;

- “middle segment” firms, who act and purchase more like small firms but who are not provided for in the direct channel. These firms will receive incremental benefits from the proposed policies if they act on the available information. Recent research on how people – even with high financial sophistication – act on information provided is not encouraging, although this research was carried out in a materially different context;\footnote{Choi, Laibson, Madrian (2006): Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds \url{http://www.som.yale.edu/faculty/jjc83/fees.pdf} The subjects of this experiments are Harvard college students and Wharton MBAs.} and

- other “middle segment” clients, who are somewhat sophisticated in their purchase of insurance but need (and want) assistance. These firms are the most likely to act on the additional information made available through the proposed policy options, especially when the information is made clearer and easier to compare (through standardisation). Therefore we expect most of the benefits that are likely to arise from proposed policy options will be in this client segment.

As yet, we do not know how many firms of each type are in the “middle segment”.

The extent of the benefits will also depend on the potential gains from shopping around, which is influenced by price dispersion in the market and the initial efficiency of the prices.