A Considered Approach in the Management of Insurance Intermediaries from the Insurer's Legal Perspective

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Introduction

Insurers, in terms of insurance product distribution, often consider and balance the many routes to market with the inherent, external costs and risks of the various routes.

This paper analyses one of the most common routes to market namely, through insurance intermediaries (limited to insurance brokers for the purposes of this paper). In particular, this paper analyses the terms of business agreements which govern these relationships, and with particular consideration of the rationale of the current tension and a conditional risk transfer.

In addition, it is considered whether a potential change of landscape would manifest pursuant to the Financial Conduct Authority (FCA)'s latest Consultation Paper CP12/20 (http://www.fsa.gov.uk/static/pubs/cp/cp12-20.pdf) and its particular impacts, such as the technical changes of rules and the recommendation of an unconditional risk transfer. For the purposes of the paper, references to “CASS Client Assets Sourcebook Rules” “CASS” refer to “Client Assets Sourcebook Rules 5” or CASS 5”, unless otherwise specified.

Finally this paper analyses whether the insurance intermediary and insurer’s approach should change to account for these potential impacts, including the scope for improvement of processes with the practical means to minimise the associated risks.

Background

The British Insurance Brokers Association (BIBA) is a membership based association of British insurance brokers which merged with the Institute of Insurance Brokers (IIB) in November 2011 (http://www.biba.org.uk/MediaCenterContentDetails.aspx?ContentID=2485) and, as a result, established a trade body of almost 2000 regulated firms to consider and lobby for the interests of insurance intermediaries. The speech published by BIBA's chief executive, Eric Galbraith, on the right of regulation makes a good introduction to the insurance intermediaries’ concerns. His statement made in conjunction with the 21st BIBA Conference, voices the aim to “…influence practical changes to the regulatory framework so that it may recognise the limited risk the sector proses to the public, to clients and to the general economy… in the spirit of the idea of proportionate, appropriate and cost effective regulation”.

The speech occasioned from the fact that fines had been levied against insurance intermediaries with final notices and prohibition orders against performing any function in relation to regulated activities. The fines, notices and orders were a result of the failures of such insurance intermediaries to ensure, where applicable, that the Conduct of Business sourcebook (COBS), the Insurance: Conduct of Business sourcebook (ICOBS) (http://fshandbook.info/FS/html/handbook/ICOBS), and Client Assets Sourcebook Rules (CASS) (http://fshandbook.info/FS/html/handbook/CASS) with respect to client money was being adhered to. BIBA, as stated above, has recognised that the protection of the
client and client money is of paramount importance, however this has to be harmonised with practicality so that the risks the insurance intermediaries pose to the industry is proportionate to the regulation they must abide to.

The main issue in this matter concerns the regulatory requirements of the insurance intermediary for ensuring the protection of its client (in particular, in respect to the Financial Conduct Authority rules as contained within the COBS, ICOBS and client money in accordance with CASS and how far that should interfere with its modus operandi.

BIBA consistently delivers this message, for instance, they say in the more recent (2013) BIBA Manifesto (http://www.biba.org.uk/UploadedFiles/760manifesto%202013.pdf),

“...we recognise and support the need for appropriate regulation of financial services and are looking for the right balance ensuring suitable customer protection aligned with proportionate regulation of insurance intermediaries.”

The above is contrasted with the FCA’s publication of its first Conduct Risk Outlook (http://www.fsa.gov.uk/static/pubs/other/fcarco.pdf) and Business Plan (http://www.fsa.gov.uk/static/pubs/plan/bp2013-14.pdf) for 2013/14, which sets out the FCA’s focus on the conduct risks identified in the report, highlighting the need for insurers and insurance intermediaries to review their structure, strategy and practices, to ensure that that they are putting the client and the integrity of markets first.

The Insurance Intermediary
From an insurance intermediary’s perspective, it becomes quite important to determine what practical measures can be in place to satisfy the regulatory requirements whilst avoiding implementing all of the requirements. It is noted that, as a practical measure, regulatory requirements are applied generally through adherence to COBS and or ICOBS with a reference to CASS, should the insurance intermediary hold client money. It is noted that practical cooperation with insurers often results in the best position, because the COBS, ICOBS and or CASS requirements are clarified within the context of a particular arrangement and or insurance products. This agreement between the insurance intermediary and the insurer contains the agreed points, including, but not limited to, product information, scope of the services, suitability of products, policy information, price, remuneration or commission, tax, cancellation rights, claims handling, applicable law, etc.

The Insurer
One of the most common routes to market for insurers, save for direct marketing, is through insurance intermediaries, in which a terms of business agreement (TOBA) is established to govern these relationships, lending a framework and platform for particular considerations to form the contractual structure.

The TOBA is a written agreement, between the insurance intermediary and the insurer. As part of the TOBA, the insurer would indicate whether or not it would allow for risk transfer (allowing for money held by the insurance intermediary to be held as agent of the insurer) and state whether any such money is held under a statutory or non-statutory trust account. Other common elements contained in the TOBA detail whether the insurer permits an insurance intermediary to co-mingle money held by the insurance intermediary as agent for the insurer (risk transfer money) with that of money held as agent of the client (client money) and, establish also that the insurer agrees to subordinate the interests and rights of the insurer to that of the insurance intermediaries’ clients, so that, in the event that the business of the insurance intermediary fails, the client’s rights shall take precedence over the insurer’s in terms of recovery of any such monies. It is of
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vital importance for risk transfer money, client money and the insurance intermediaries’ own money to be properly segregated because it is a regulatory requirement (CASS) but also because English law considers assets that are subject to a trust usually have to be segregated from the trustee’s own assets in order for the trust to be effective (In Re Goldcorp Exchange Ltd [1995] 1 AC 74).

Practical Measures
As a general rule, insurance intermediaries holding client money need the appropriate authorisation from the FCA so that any such insurance intermediaries must operate under CASS and must manage the associated costs of implementing such requirements, including, but, not limited to, ensuring the proper segregation and placement of client money, record keeping, reconciliation, governance and periodical reporting to the FCA. Client money is then protected in the segregation, declaration, placement and reconciliation of the client money thereby establishing that the money belongs to the client.

As an example of such requirements, insurance intermediaries hold client money under either a statutory or non-statutory trust account (the difference being that the latter allows the insurance intermediary to advance credit out of client money either to a client or an insurer whereas such advances are prohibited with the former), but, the point to note is that firms are to have in place a trust deed as a requirement for having non-statutory trust accounts. CASS then require that insurance intermediaries who operate a non-statutory trust account, or a statutory trust account holding more than £30,000, perform an annual client money audit.

As CASS do not generally extend to risk transfer money, it was recognised that, a realistic and expedient alternative is needed in respect of the protection of clients and client money. The alternative proposed would be for insurers to agree for insurance intermediaries to hold, on a risk transfer basis, the insurer’s monies, instead of such money being held as client money for the purposes of CASS. This entails the explicit agreement that at the point of receipt from the insurance intermediary of any such money from the client due to the insurer, it was deemed to have been received by the insurer – although very often, in practice, it takes an additional 30-90 days, depending on the purported credit period as agreed between the particular insurer and insurance intermediary, before the premiums are actually received by the insurer. Whilst the insurance intermediary and insurer retain this agreement in place, the credit risk of the premiums is deemed to have been transferred to that of the insurer.

As risk transfer is ultimately about protecting client money (in the event of the insurance intermediary’s insolvency) by transferring a financial risk from the client to the insurer and mitigating the administrative burden for the insurance intermediary. it is therefore important for the insurer to determine how and to whom risk transfer is given.

Insurers balance this financial risk with its risk appetite, by taking into account its own financial standing, regulatory requirements and contemplating the insurance intermediaries’ financial standing, systems and governance and gleaning whether, by extending risk transfer to any such insurance intermediaries, there is an associated adverse impact on itself.

The relevant regulatory requirement consideration would be for the insurer to ensure that it identifies any such credit risk and mitigate it accordingly. The Prudential Regulation Authority (PRA) states generally that it is important that sound and legally enforceable documentation is in place for each agreement that gives rise to credit risk, that a firm should consider whether it is appropriate for an independent legal opinion to be sought on documentation used by the firm; and that documentation should normally be in place...
before the firm enters into a contractual obligation or releases funds. In addition to the requirement to manage credit risk, limits such as counterparty and asset limits are also imposed on the extent to which assets can be used to cover liabilities or capital (as per INSPRU 2.1.22R http://fshandbook.info/FS/html/handbook/INSPRU/2/1). In addition, the insurer would be required to adhere to the requirements of the Solvency II Directive (2009/138/EC) (Solvency II).

Hence, to cater for the above financial risk, it becomes prudent for the insurer to dictate requirements in exchange for providing any such risk transfer, hence, making any such risk transfer conditional (conditional risk transfer).

In practice, conditional risk transfer is whereby the insurance intermediary is required to perform a certain obligation in relation to the premium received by the insurance intermediary from the client, such as the fact that risk transfer is granted on the condition that money should be transferred to the insurer within a particular timeframe, and the failure of which could then result in the monies losing risk transfer status and resulting in the relevant insurer no longer taking on the financial risk. Should an insurance intermediary become insolvent and such conditions were not met, the financial risk then reverts back to whether or a trust account was properly constructed for the benefit of clients. This potentially leaves the client exposed to financial risk and uncertainty as per Re Lehman Brothers International (Europe) (In Administration) [2012] UKSC 6 (29 February 2012 (http://www.bailii.org/uk/cases/UKSC/2012/6.html).

**Consultation Paper CP12/20**

The Financial Conduct Authority's Consultation Paper CP12/20 (http://www.fsa.gov.uk/static/pubs/cp/cp12-20.pdf) made recommendations which affect insurers, insurance intermediaries and clients. The paper details reminders and recommendations by the FCA to revise CASS.

The FCA reminded insurance intermediaries that all risk transfer money must be held as client money and that all insurance intermediaries must have the appropriate authorisation from the FCA to hold client money and must adhere to CASS. The recommendations largely concern the tightening of system and administrative controls, for instance the proposals to ensure that client money calculation and reconciliation is conducted at least every 7 days, with the exception for firms who hold less than £250,000 and to ensure that any credit extended out of the non-statutory trust account is replaced within 45 days for clients and 90 days for insurers, either by arranging for the monies to be returned from the client, arranging the required financing, or for the insurance intermediary to pay into the client account, utilising the insurance intermediaries’ own money.

The recommendation which slightly departs from the above is the recommendation of an unconditional risk transfer, namely the requirement for insurers to provide risk transfer without conditions attached.

The rationale for the change originates from differing conditions imposed by insurers in their respective TOBAs and the concern that if risk transfers continue to be granted on a conditional basis, the potential inconsistency of approach by insurers and or insurance intermediaries might render inefficient the protection afforded to the client.

**Impact on insurance intermediaries**
Some key proposals as detailed in the paper which impact on the insurance intermediary are namely:

- clarifying when commission can be withdrawn from the client bank account;
- setting out the position when an insurance intermediary is unable to complete an insurance transaction due to its insolvency;
- recommending that prior consent is acquired by the insurance intermediaries from clients so that client money can also be transferred without first obtaining consent from all relevant clients to avoid delay in circumstances where insurance intermediaries acquire or merge books of business. As this opens up a potential detriment, the insurance intermediary would then be required to notify the FCA in advance of any such a proposed transferred so as the FCA may object, as necessary;
- settling out rules to clarify such trust letters in terms of the signatory, format, as well as reinforcing the requirements to have such trust letters in place, so further consistency is established with other rules such as CASS 7;
- clarifying when commissions can be withdrawn, and setting out rules to clarify the required formation of trust letters, tightens the segregation rule and reinforces the legal principles associated with trust law.

In respect of client bank accounts, an insurance intermediary currently should request confirmation from the bank holding the account to acknowledges that the money is held by the insurance intermediary as trustee, that such money is separate and distinct to any other monies held by the insurance intermediary, and that it is not available to the insurance intermediary.

BIBA has provided its members (insurance intermediaries) with suggested wording which forms the template from which requirements are checked against. As BIBA recognises that trust letters contain certain elements, it has prepared a template accordingly. In spite of the non-binding nature of the use or compliance with the template wording, the template wording became a generally accepted standard.

The paper sets out the position when an insurance intermediary is unable to complete an insurance transaction due to its insolvency and included the consideration that it would be more beneficial to clients for insurance transactions to be completed, so, the ultimate remedy for any such clients becomes an entitlement to the benefit of an insurance cover instead of the entitlement to the refund any premiums transacted (even if the refund concerned was protected as client money). The merit of this approach is to provide a realistic and practical solution to account for clients’ needs and better protect the client (as if clients were placed in the position as if the insurance transaction had been duly completed).

It is clear from the consultation paper that if recommendations are implemented, insurance intermediaries would potentially face the tightening of system and administrative processes and should ensure that there are relevant systems in place for a smooth and seamless implementation. This can be beneficial to both insurance intermediaries and insurers alike as long as they are positioned with ample budget to invest in a system to support change.

Insurance intermediaries might want to take into account the recommendations and take steps to addressing concerns of the FCA, especially in areas which the FCA has identified as having failings and potential gaps, since the paper indicated the aim by the FCA was to conduct a thorough review of the current regulatory requirements.

Any steps taken by insurance intermediaries to prepare for the recommended proposals would be time and resource intensive at this stage as the proposals have not been
finalised, although improvements that allow insurance intermediaries to operate in line with the recommended proposals would assist with the final implementations of a new reform.

As the revision of CASS renders a potential higher time and resource cost for insurance intermediaries, insurance intermediaries should address any system and administrative failures and gaps as highlighted by the FCA in its paper, so their systems and processes are at least compliant with the current CASS.

**Impact on insurers**

One of the key proposals as detailed in the paper which impacts on the insurer is namely:

- the introduction of an unconditional risk transfer, whereby the TOBA must be entered into between the insurance intermediary and the insurer with prescribed wording, indicating that the risk transfer is provided under no qualifying or contingent conditions.

Currently, recognising the important role which the insurance intermediary plays in terms of distributing its insurance products, the insurer, generally weighs a potential new product distribution opportunity with due diligence, especially in terms of adherence to the obligations imposed by the regulators (including but not limited to the FCA, PRA, Information Commissioner’s Office, etc) and practical considerations such as the credit risk, and thereafter agrees to provide any such insurance intermediaries with conditional risk transfer in accordance with the terms of the TOBA.

In respect of these conditions, there is a discrepancy on the range and detail to which insurers stipulate to satisfy it, of whether an insurance intermediary is suitable to be provided with risk transfer, for the reasons mentioned.

Considering that the FCA (then FSA) have a commitment towards reviewing regimes against intended outcomes and in the context of a more principles-based regulation ([http://www.fsa.gov.uk/pubs/other/principles.pdf](http://www.fsa.gov.uk/pubs/other/principles.pdf)), “…moving away from dictating through detailed, prescriptive rules and supervisory actions how firms should operate their business”, the proposal for unconditional risk transfer with prescribed wording may be a surprise to the insurance industry.

It is possible that a prescriptive approach by the FCA may result in insurers withdrawing risk transfer or limiting it, in order for the insurer to comply with its own regulatory requirements, such as Solvency II. Insurance intermediaries would then be required to maintain any such client money in accordance with CASS, which, whilst sensible, may not significantly add to the process.

**Conclusion**

At this point of time, with the FCA considering all responses from the various participants of the insurance industry including, but not limited to the insurance intermediaries, insurers, trade bodies and other consultancies (such as auditing firms), it is anticipated that most proposals and recommendations that support a tighter system and administrative control, are likely to go ahead within a reasonable period for implementation, and insurance intermediaries should ensure that they are proactively mitigating the relevant risks identified by the FCA within their businesses.

With the delay of a follow up policy statement due in Quarter 3 or 4 of 2013, it is not clear what format the proposed unconditional risk transfer would take or if it would proceed, especially since the paper has been heavily commented against.

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