

# COMPLIANCE RULES



Welcome to this special edition of *Compliance Rules*, BIBA's regular update on regulatory issues. This edition is concerned solely with the industry solution in respect of conflicts of interest, transparency and disclosure in the commercial insurance market.

#### Industry guidance

– The FSA has reviewed the industry solution and confirmed 'industry guidance' status for it. This confirmation means that it will take it into account when exercising its regulatory functions. The industry guidance is not mandatory and is not FSA guidance.

**A copy of the industry guidance is available on the BIBA website.**

The practical effect of this confirmation is that in the event of a breach of the relevant requirements, the FSA would take into account a firm's adherence to this guidance in any enforcement action. This guidance provides firms with one approach to meet the relevant FSA requirements – it does not represent the only means of achieving compliance. Firms that decide to adopt a different approach will not be presumed to be non-compliant by the FSA.

It is important to stress that industry guidance can only be granted based upon existing

FSA Rules and Principles and so it does not impose 'new' requirements upon firms. However, it does seek to provide greater clarity to firms about what is required of them.

For example, the FSA's Rules do not obligate firms to have a TOBA with their commercial customers – brokers have chosen to use a TOBA as an appropriate method of delivering key information, including certain FSA disclosure requirements. What the FSA Rules do require is that the commercial customer is given certain contract-specific disclosures pre-sale, but a pre-printed TOBA that every customer gets does not fulfil the Rule requirements if it is not adjusted to meet those situations where the TOBA disclosure is not accurate. This might happen in respect of the breadth of choice of insurer or the capacity in which the broker is working. The industry guidance gives firms help in making the required disclosures in a more accurate manner.

#### The FSA and the future

– In the FSA's *Feedback Statement* FS08/7, it stated that its supervisors will be continually monitoring how firms are responding to the outcomes for customers. In 2010/11, they will be assessing whether customers

are receiving sufficiently clear and comparable information about intermediaries' services, capacity and remuneration. The inference both from the *Feedback Statement* and discussions we have had with the regulator is that they are quite prepared to mandate disclosure if the industry does not adequately address the outcomes for customers.

It would be foolish to simply consider the conflicts, transparency and disclosure debate as a British issue, or as just an issue solely of interest to the FSA. There is a global movement towards greater transparency. The legislators in New York have draft laws in place which will mandate the disclosure of commission, due to come into force in Autumn 2009. There is also a growing debate in Europe, where the Markets In Financial Instruments Directive (MIFID) has imposed disclosure requirements on certain life products for the first time.

**Industry guidance** – the rest of this edition of *Compliance Rules* sets out in more detail the outcomes for customers and how the industry guidance addresses them, BIBA's top 10 tips on how to implement and concludes with a message from Eric Galbraith, BIBA's Chief Executive.

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### THE INDUSTRY GUIDANCE – WHAT DOES IT CONTAIN?

As stated on page one, the FSA can only grant industry guidance status to material based upon current Rules and Principles. For this reason, the industry guidance is based on the current 'disclosure upon request' system.

The industry guidance has been designed to address the outcomes for commercial customers that the FSA are seeking, namely:

**Outcome 1:** Commercial customers should have clearer and more comparable information about the commissions intermediaries receive

**Outcome 2:** Commercial customers should have clearer and more comparable information about the services intermediaries are providing

**Outcome 3:** Commercial customers should have clearer information about the capacity in which an intermediary is acting

**Outcome 4:** Commercial customers should be alerted to their right to request commission information

**Outcome 5:** Commercial customers should be made aware where there is a chain of intermediaries.

These outcomes are addressed in a series of sections within the industry guidance.

**Conflicts of interest** – the FSA Rules and Principles require firms to take all reasonable steps to identify conflicts of interest between themselves and a client. The industry guidance explains to insurance brokers that they face a conflict of interest where the firm's own interests conflict with those of a commercial customer; or the firm is unable to act in the best interests of one commercial customer without adversely affecting the interests of

another commercial customer.

The industry guidance goes on to state that it is the duty of an insurance intermediary to manage conflicts of interest so that the intermediary's interest does not conflict with the interests of commercial customers and of any insurers on whose behalf they may act. In this way, the insurance intermediary will ensure that conflicts of interest arising from remuneration arrangements or business models are properly disclosed and managed. An insurance intermediary may manage such conflicts either by disclosure or withdrawal from the engagement.

The industry guidance suggests to firms that they establish their own internal conflicts of interest management policy. It reminds firms that the FSA's Rules require that they must take reasonable care to establish and maintain such systems and controls as are appropriate to its business and that they must maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps to prevent conflicts of interest from constituting or giving rise to a material risk of damage to the interests of its clients.

Furthermore, the industry guidance suggests how to build suitable conflict management controls, the circumstances in which conflicts of interest might arise and points out that insurance brokers need to be able to demonstrate that they have in place rigorous internal controls for identifying and managing potential conflicts of interest and a mechanism for preventing them adversely affecting the firm's commercial customers.

BIBA has previously published two guidance notes for members on conflicts of interest. The first, in 2005, gave guidance on how to identify and manage potential conflicts of interest. The second, in 2006, provided guidance in how to create and

implement an internal conflicts of interest policy. These documents are still available to members – email your request to Steve or Vanessa.

**Capacity** – The conflicts of interest section of the industry guidance concludes by suggesting that one way to help manage conflicts of interest that arise from commercial relationships is to give the commercial customer clear information about the capacity in which an insurance intermediary is acting – ie, whether it is acting for them, for the insurer or, in some cases, for both. The industry guidance reminds firms that the relationships they have with commercial customers and insurers can potentially lead to conflicts of interest and that clearly describing the capacity in which they are working to a commercial customer is one way of mitigating any conflict. However, it goes on to point out that it would not be sufficient to simply rely on a generic statement in a TOBA to describe capacity – this needs to be done contract by contract and of course it can vary.

The industry guidance contains, in an annex, a template form which firms can choose to use which will clearly explain to the commercial customer the capacity in which the intermediary has searched the market, placed the insurance, and will handle a claim (if appropriate).

**Status/breadth of search** – During its Forensic Review in 2007, the FSA's researchers found that commercial customers generally overestimated how much searching of the market the broker has undertaken. This is sometimes fuelled by generalised statements in TOBAs which do not match the actual circumstances. The FSA's Rules require that firms must take reasonable steps to communicate information in a way that is clear, fair and not misleading.

The industry guidance reminds firms that the status and product disclosure requirements apply separately in respect of each contract and so the commercial customer must be informed of the breadth of choice on a contract-by-contract basis. The FSA's Rules require the breadth of choice to be described as either a 'fair analysis', whether it is under a contractual obligation to conduct insurance mediation business exclusively with one or more insurance undertakings, or 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. The industry guidance gives brokers assistance on when the breadth of choice they offer can be described as a 'fair analysis'.

The annex referred to above will also cater for the disclosure of the breadth of search.

### **Commercial customer's right to commission information and disclosure**

The industry guidance maintains the current 'upon request' disclosure regime, but gives direction on how brokers can give greater prominence to the commercial customer's right to ask for commission information. FSA research shows that a significant number of commercial customers are unaware that they have the right to know how much commission their broker receives.

The industry guidance states that simply including a statement in the TOBA would not be sufficient and suggests that it should be made in either:

- the covering letter that might accompany a written quotation
- a document of no more than one page in length
- or**
- orally.

Where the commercial customer exercises the right to request commission information, the industry guidance points out that firms should have in place processes to ensure that the commercial customer receives a full, accurate and timely disclosure of the total commission payment. BIBA issued guidance to members in 2007 on how to create and implement a process to make the requested disclosure. Again, please contact Steve or Vanessa if you would like a copy of that guidance.

The industry guidance goes on to assist firms in how to disclose the value of any contingent arrangements they may have, such as profit share or volume over-rides.

The annex previously mentioned can be used as a method of giving greater prominence to the right to ask about commission statement.

There is a further annex in the industry guidance which could assist firms in standardising the requested disclosure of commission and contingents.

### **Distribution chains**

The industry guidance reminds firms of their obligation to provide clear, fair and not misleading information. With this in mind, the industry guidance suggests that brokers inform the commercial customer where they have used the services of another intermediary in the placing of the insurance.

### **What is not included?**

The FSA's Discussion Paper DP08/2 set out its original proposals, a couple of which have not been incorporated in industry guidance.

**Total remuneration** – The discussion paper mentioned the disclosure of the total commission in the distribution chain, upon request. While industry guidance does not include this, there remains the possibility that, having told the commercial customer about the existence of others in the

distribution chain, a request may be made for the total remuneration in the chain. Under these circumstances, it would be prudent for the broker to use best endeavours to try and establish the total commission.

### **A 'reasonable' deduction for work transfer**

– The FSA's ICOBS rules state that 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.

The term 'commission' is defined in the FSA Glossary as 'any form of commission or remuneration, including a benefit of any kind, offered or given in connection with insurance mediation activity in connection with a non-investment insurance contract'.

The combination of the disclosure rule and the definition of commission obligates intermediaries to disclose the total remuneration, not allowing any deduction for payments relating to matters such as work transfer.

Where an intermediary receives an enhanced remuneration from an insurer for undertaking work on the insurer's behalf, the intermediary may choose to break down the total disclosure into standard commission plus the work transfer element.

### **What happens next?**

BIBA has offered the FSA a suite of support activity for the industry guidance, which not only includes the publication of this special edition of *Compliance Rules*, but will also include a series of half-day training events around the UK. Full details will be available shortly on the BIBA website and from your usual BIBA regional contact.

It is important at this point, though, to point out that BIBA's activities will be restricted to the promotion of the industry guidance. We will not be monitoring, measuring or policing adherence to the industry guidance – we are your trade body, not a quasi-regulator or agent of the FSA!

## BIBA's top 10 tips on implementing industry guidance

**One** – check your current processes, procedures and documents in relation to the accuracy of the disclosures concerning the breadth of search and the capacity in which you are working. Remember – these disclosures must be contract-specific.

**Two** – look again at the terms of business agreements (TOBAs) you have with your commercial customers. Do they contain generic descriptions of searching and your capacity? If so, your TOBA or processes may require amending.

**Three** – if you decide to change your current methods, consider using the annex template from the industry guidance, or use a TOBA that can easily be adjusted to suit the contract-specific searching and capacity.

**Four** – do you already inform commercial customers that they have the right to ask you about the commissions you receive? If you do, how prominent do you make this? Remember, industry guidance states that it is not sufficient simply to rely on inserting a statement into your commercial customer TOBA.

**Five** – when you use the services of a wholesale broker or MGA for the placing of a commercial insurance contract, do you notify the commercial customer that you have done this? Industry guidance reminds firms that commercial customers should be made aware of the presence of others in the distribution chain.

**Six** – how well developed are your internal policies and processes for identifying and managing potential conflicts of interest that might arise in your business? BIBA has produced two very helpful guidance papers on how to

identify and manage conflicts and how to design and implement your own internal conflict management policy. Now might be a good time to fundamentally review your whole approach to conflicts management.

**Seven** – do you have a formal process to disclose commission upon request to commercial customers? It is not sufficient to simply say that we have had no requests and therefore do not need a process! BIBA issued a guidance note in 2007 assisting firms in creating and implementing a disclosure process. If you already have a process, are you sure your staff know what it is?

**Eight** – The FSA has found that commercial customers often are unaware of the services provided by their broker. Do you clearly set out for your commercial customers details of the nature of the services you provide for them? If not, it would be a very prudent thing to do. Clearly, the nature of these services will vary depending on the customer and the complexity of the risks involved. When designing a schedule of services, you could include the specific activities you undertake at the new business stage, mid-term and at renewal. You could also include details of your claims service, the day-to-day support you can make available and, most importantly, the expertise that you can make available and the extent of your advice.

**Nine** – what plans do you have to train your staff and increase their awareness of any changes you make to processes, procedures or documentation as a result of implementing the industry guidance? BIBA will be running a series of half-day training sessions around the UK as part of our efforts to inform firms about the contents of the industry guidance and to encourage

its use. It would be prudent for firms to supplement this with their own internal awareness training.

**Ten** – and last, where you do make a change to the ways you are currently doing commercial business, it would be prudent to keep a formal record of the changes. The FSA will be conducting a thematic review in 2010 / 2011 and it will be looking for evidence that firms have improved the clarity and accuracy of the information they give commercial customers.

### A message from Eric Galbraith, BIBA Chief Executive

*Members will be aware that BIBA's compliance team has been leading the development of an industry solution for some considerable time. This has involved discussions with LIIBA (formerly BIBA's London Market Insurance Brokers' Committee, LMBC), ABI, IIB, LMA and IUA, proving that their solution does have significant cross-sector support.*

*I am delighted that this hard work has resulted in formal industry guidance status, with no imposition of further rules. The industry guidance is, in my opinion, an appropriate and proportionate response to the concerns the FSA has been raising since 2005 and gives the broking sector the chance to take positive steps to improve the quality of the information we give to commercial customers.*

*I would encourage all intermediary firms to work through the top 10 tips and to record details of the changes they make. The signal from the regulator is crystal clear – if the industry guidance does not lead to improvements for commercial customers, mandatory disclosure is likely to be imposed.*

## Your Contacts

We hope that you will find this issue of *Compliance Rules* useful. If you have any comments about the content or have ideas for future issues, please contact either



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