Financial Conduct Authority

Thematic Review TR14/9

Commercial insurance intermediaries – Conflicts of interest and intermediary remuneration

Report on the thematic project

May 2014

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1. Executive summary

What does this report cover?

Small and medium-sized enterprises (SMEs)[1] play a vital role in the UK economy. At the start of 2013 there were an estimated 4.9 million private sector businesses, 99.9% of which were SMEs, employing over 24 million people.[2] SME businesses need to be able to access insurance products to protect their businesses against the risks of things going wrong, and the majority rely on the services of insurance intermediaries to help them buy insurance.[3]

We set out to establish how general insurance intermediaries identify and manage potential conflicts of interest where they receive revenue from both their customers and insurers. We wanted to understand whether the flow of revenue from insurers or other sources to intermediaries arranging insurance for UK SME customers, particularly when acting as their agent, might:

- unduly influence the intermediary to recommend an insurer against the customer's best interest
- cause an intermediary to improperly perform its duties to its customer

Insurance intermediaries' business models have evolved over time. We have seen that some intermediaries have worked to expand their role in the distribution chain, taking on functions that are traditionally associated with the insurer in exchange for additional remuneration.

We have considered the identification and management of conflicts of interest in relation to general insurance intermediaries arranging insurance for UK SME customers, to better understand what conduct risks this may present. We focused on these types of customers because we believe that many SME customers (particularly micro SME customers) are unlikely to be sophisticated buyers of insurance, so they may need similar levels of protection to retail consumers. We also wanted to understand the expectations of SME customers in terms of what services they expected of intermediaries when arranging their insurance and whether these aligned to what is actually being provided.

1 The Department for Business Innovation and Skills describes businesses with 0-49 employees as small businesses and businesses with 50-249 employees as medium businesses. The Federation of Small Businesses further segregates the small category into micro (0-9 employees) and small (10-49 employees) categories. We have used these definitions in our work and this report.

2 Department of Business, Innovation and Skills Statistical Release: www.gov.uk/government/uploads/system/uploads/attachment_data/file/254552/13-92-business-population-estimates-2013-stats-release-4.pdf

3 BIBA has reported that insurance intermediaries arrange 81% of all commercial insurance business: www.biba.org.uk/AboutBIBA.aspx

SME insurance customers are diverse, so intermediaries provide a variety of services to meet their needs. In doing this, they can act in different capacities - as agent of either their customer or of the insurer, with additional regulatory obligations and common law fiduciary duties falling on them where they provide advice or act as agent of the customer.

In some cases an intermediary may play a number of different roles in the distribution chain (e.g. where a broker acting as agent of the customer and a managing general agent[4] (MGA) sit within the same group). This dual role and the enhanced remuneration that can be derived from it, is likely to give rise to conflicts of interest.

How firms treat their customers is central to our expectations of their conduct - we expect customers to be at the heart of how firms run their businesses. We therefore attach a considerable degree of importance to how intermediaries consider conflicts of interest and take steps to mitigate them, in accordance with the rules and guidance set out in our Handbook.

This report sets out our findings and how they relate to the rules and guidance set out in our Handbook which general insurance intermediaries are required to comply with, particularly Principle 8 and the provisions of SYSC 10 that are applicable to insurance intermediaries (as non-common platform firms[5]).

What did we find?

Conflicts of interest are inherent in many general insurance intermediary business models. So it is important that intermediaries put in place effective control frameworks to identify, mitigate and manage the risk that conflicts arising within their business could damage the interests of their customers.

SME customers often have more complex insurance needs than retail consumers and our research showed that a large majority of SME customers expected to receive advice when using an intermediary to arrange their insurance. This indicates a degree of reliance and importance attached to receiving appropriate advice from intermediaries.

We found that control frameworks and management information in some firms had not developed at the same pace as their business models, so they were no longer commensurate with the size of the firm or the complexity of the firm's business. This has resulted in conflicts of interest that do not appear to be either fully understood or effectively mitigated.

Many of the conflicts of interest we identified relate to the **structure of intermediaries' businesses** and their **sources of revenue**. In particular, firms or groups with business models incorporating both broking (acting as agent of the customer) and insurer agent (including MGA) operations were more exposed to conflicts of interest because of the multiple roles they fulfil in the distribution chain and because they often act as agent for both customer and insurer in relation to the same transaction. The risk of conflicts of interest arising in these business models were exacerbated where there was not clear segregation of roles, revenues and information between these operations.

4 The Managing General Agents' Association defines an MGA as an 'entity that underwrites insurance risks, and who owes its primary duties to one or more insurance companies, Lloyd's syndicates or other providers of insurance capacity'.

5 Common platform firms are defined within the FCA Glossary.

Some of the intermediaries did not appear to have constructed **management and control frameworks** that effectively address the conflicts of interest created by their business model. In particular, the management information available to firms' senior management often did not appear to be of sufficient scope or quality to allow senior management to be confident that conflicts had been effectively mitigated so that customers' interests were always being served.

An example of this was in tender and review processes for new and existing insurance products. These processes were not always documented and evidenced and sometimes appeared to focus predominantly on remuneration, with little consideration of customer needs. Some firms appeared to rely largely on **disclosure** (per ICOBS requirements) to mitigate any shortcomings in their management and control frameworks, but this approach is not consistent with their SYSC obligations (as set out in SYSC10.1.7-9).

Some of the disclosure provided to customers was very generic and unlikely to meet their information needs or enhance their **understanding** (of the services and product provided). Our research revealed that many SME customers did not appear to fully understand the nature of the service that was being provided to them.

The combination of all of these factors means it is possible that the conflicts of interest in some intermediaries could result in customer detriment.

We also identified conflicts of interest risks in **add-on insurances and services, premium finance** and **insurances where the cost is borne by another party** (e.g. property owners) that did not always appear to have been effectively mitigated.

What concerns do we have?

The failure to properly manage and mitigate conflicts of interest potentially increases the likelihood that individual broking and placement decisions are made in the interests of the firm rather than their customers. This could result in some SME customers paying more for core insurance products than they need to, purchasing add-on insurances and services that they may not need or paying more for secondary products like premium finance.

This issue is further exacerbated by the lack of customer understanding of the nature of the service being provided to them. The combination of some firms' lack of effective mitigation of the conflicts arising from their business model and the gap between customer's expectations makes it challenging for some general insurance intermediaries to adequately demonstrate that they are always working in the best interests of their customers when arranging their insurance.

Our review focused on conflicts of interest affecting the sourcing and placement of SME customers' risks. However, our concerns regarding some firms' ability to manage and mitigate conflicts of interest also extend to other conflicts that exist in an intermediary business, particularly in relation to claims management.

These conflicts include dual agency and where the intermediary has a financial incentive to act in the interests of the insurer (e.g. where a profit commission exists). We will factor these concerns into our forthcoming thematic review of commercial claims.

2.
Our findings

How did we carry out our review?

We reviewed information in the second half of 2013 and early 2014 from a sample of seven large intermediaries/intermediary groups providing services to UK SME customers. This information included details of these firms' and groups' revenue and premium flows, their largest insurer markets, significant enhanced commission arrangements with insurers, conflicts of interest policies, product tender and review documentation, Chinese Walls[6] and key management information.

We carried out a desk-based review of the information provided, as well as meeting with each of the firms in the sample. In parallel with our interaction with intermediaries we met with a sample of insurers underwriting UK SME business.

This work gave us a clear view of the actual or potential conflicts of interest in these intermediary businesses, particularly in relation to broking, placement and market selection, and the effectiveness and completeness of the controls and management information in place to mitigate these.

We also surveyed a sample of 1,000 UK SME business owners buying insurance so that we could better understand their expectations of the insurance intermediaries that help them. The survey questions considered these customers' expectations of the roles played by insurance intermediaries, who the intermediaries were acting for, the scope and nature of market search that the intermediaries perform, the remuneration intermediaries receive and the disclosure provided to customers.

What did we find?

Our review highlighted an evolution in the business models and remuneration structures of some intermediaries, which has resulted in a range of conflicts of interest that could influence the placement process.

In some instances there was a lack of evidence that these conflicts had been sufficiently understood by the intermediary and that all reasonable steps had been taken to mitigate the risk of them giving rise to customer detriment.

6 A Chinese Wall is defined in the FCA Glossary as 'an arrangement that requires information held by a person in the course of carrying on one part of its business to be withheld from, or not to be used for, persons with or for whom it acts in the course of carrying on another part of its business'.

Structure of intermediary businesses and sources of revenue

Evolving business models and new sources of revenue

All of the intermediary firms included in the review acknowledged that the intermediation of SME insurance business had evolved over the last ten years. One of the key features (particularly in relation to micro SME customers) is a considerable degree of commoditisation. This has resulted in intermediaries placing many SME insurance risks to insurer products (available to the intermediary via a binding authority[7] or MGA) without undertaking any (re)broking activity for that individual risk. Therefore many individual SME customers' insurance risks are placed with a market without other placement options having been considered.

Within our sample, some intermediaries still earned as much as 90% of their revenues from broking commissions and fees earned as agent of the customer, suggesting a more traditional insurance broking model with more risks placed following (re)broking activity. In other intermediary firms in our sample that described themselves as insurance brokers, this figure was as low as 30%, suggesting that risks were more likely to be sourced and placed as agent of the insurer. In MGAs this figure was generally zero, with all revenues earned as agent of insurer, which is consistent with this business model.

Revenues other than ordinary commissions and broking fees made up over 20% of some intermediaries' revenues. These included premium finance (up to 7% of revenues), administration charges (up to 7% of revenues), commissions on add-on insurances (up to 2% of revenues) and over-riders and contingent commissions (up to 10% of revenues). These revenues were often a significant driver of profitability for these firms.

We noted that where intermediaries increasingly earn commissions as agent of the insurer or in a dual agency capacity, but continued to purport to be independent insurance brokers, acting for the customer, this increases the risk of customers misunderstanding the role they are performing in arranging their insurance.

Increased level of conflicts in integrated intermediaries

Firms and groups operating more traditional broking models – with a greater proportion of risks placed following (re)broking exercises and a greater proportion of their revenue earned as agent of the customer – appear less exposed to conflicts of interest. These firms and groups may have particular areas or product lines where they act as agent of the insurer or in a dual agency capacity, but this was often clearly defined, involving dedicated staff in different teams or locations.

MGAs, operating solely as the agent of the insurer, appear to have minimal exposure to conflicts of interest, as long as there is no ambiguity in communication and interactions with their customers.

Firms and groups operating integrated models including a mixture of open-market broking activities alongside and in conjunction with activities where they act as agent of the insurer (including MGAs) are likely to have more inherent conflicts of interest in their business models. This is because of the range of activities they are performing and because the firm or group may act as agent of both the customer and the insurer in the same transaction.

7 An agreement between an insurer and an intermediary under which the insurer delegates its authority to enter into a contract or contracts of insurance to the intermediary.

In more integrated business models incorporating both broking activities (acting as agent of the customer) and activities performed as agent of the insurer, there was sometimes a lack of clarity over who the firm (or business units within the firm) was acting as agent for and the different ways in which an individual product could be provided to an SME customer.

Firms' management could not always articulate or demonstrate whether the decision to place an SME customer's insurance risk to a particular product was made by an individual broker or had effectively been taken at the point when the insurer was selected to underwrite that product. Firms were also unsure about whether this could vary customer by customer, with a single product potentially used in a variety of different ways within the same intermediary.

In firms and groups with integrated models, promotional communications were often sent from the MGA responsible for designing and reviewing insurance products (or other teams acting on behalf of the insurer) to the customer-facing broking areas. These communications sometimes focused predominantly on the enhanced remuneration attaching to the scheme and other benefits to the firm rather than on customer benefits. They also created ambiguity over how individual brokers should use them, creating the risk that brokers might use them in a way that could run contrary to their fiduciary obligations to their customers.

Example 1

An internal marketing communication sent from an MGA (acting as agent of the insurer) to broking staff (acting as agent of the customer) in the same intermediary group highlighted a new product and described the MGA as the preferred partner of the broker for this product. The communication began its description of the key benefits of the product as follows:

Key benefits provided include:

- *Remuneration*
- *40% commission for all products except the _____ service*
- *30% commission for _____*
- *Book roll over terms*

We can provide a discount of up to 10% on expiring terms on cases which are claim free, if required, to move the business in addition to the benefits outlined in the attached documents.

The communication also went on to describe the client benefits of the product, but the emphasis placed on the commission levels available and the provision of this information to customer facing broking staff creates a conflict of interest and increases the risk that business might be placed to maximise revenue for the intermediary rather than in the best interests of the customer.

Integrated models greatly increase the need for clear controls and management information to address the potential conflicts of interest in the selection and placement process and to help demonstrate that all reasonable steps have been taken to mitigate the risk these conflicts pose to the interests of customers. Firms' historic control frameworks and management information had not been designed to identify and mitigate these new and evolving conflicts of interest.

In some cases these did not appear to have been enhanced or reviewed in response to the changes in firms' business models. So it was not always possible for these firms to demonstrate that there was an effective control framework in place and that all reasonable steps had been taken to mitigate the risks of customers' interests not being served by the placement process.

Remuneration arrangements and segregation of information

Most firms had segregated the areas responsible for broking and insurer agency activities (in terms of entities, locations, reporting lines and knowledge of remuneration arrangements) while this segregation (particularly in relation to remuneration information that could produce conflicts of interest), was less evident in other firms. Overlap between these areas and a lack of clarity around the roles each area is performing made it more difficult to demonstrate that the conflicts of interest had been appropriately managed.

Where enhanced remuneration arrangements had been secured in various formats the Chinese Walls that were in place were also not always applied consistently to all forms of remuneration, which could impact their efficacy in preventing conflicts from arising.

In some firms over-riders and other enhanced commissions are typically flat percentages of relevant gross written premium (GWP) agreed centrally with insurers (often in the range 1-3%) and accrued centrally, with retail broking staff having no knowledge of these arrangements. This approach helps to mitigate the risk of these enhanced commissions giving rise to placement conflicts of interest.

In other cases, over-riders and other enhanced commissions (including those related to work transfer[8] from insurers) formed part of a single remuneration package for a particular product and were known to retail broking staff. Where this enhanced remuneration included work transfer payments, these could act to increase commissions by as much as 15%, giving rise to significant potential conflicts of interest around the placement decisions made by individual brokers.

Example 2

A number of products arranged by an MGA are used by retail broking offices within the same group and produce commissions of 30-45% for the group as a whole, including work transfer and over-riders, whereas the normal retail broking commissions for equivalent products arranged via the open market was materially lower (often 20-25%).

The full commission is initially booked to the retail broking office profit and loss account. This creates a potential conflict for individual retail brokers acting as agent of the customer because of the clear commission differential between these products and equivalent open market products.

8 Work transfer commissions are amounts earned by intermediaries for performing additional tasks in relation to the distribution and administration of an insurance policy which are commonly performed by the insurer.

Management and control frameworks

Systems, control frameworks and management information

The majority of the intermediaries in the sample were unable to provide accurate summary information about how their SME customers' insurance policies had been sourced and placed. Essentially, firms didn't know what proportion of their SME customers (by value or number) had had their insurance policies sourced by open market broking, by using a panel of insurers, placed to a preferred facility or binding authority after consideration of other options or placed to a single insurer without consideration of other markets.

A number of firms were also unable to detail in how many cases they acted as agent of the customer, in a dual or mixed agency capacity, or as agent of the insurer. This information was not available in relation to the business as a whole or in relation to particular groups of customers or products. The absence of this or equivalent information made it difficult to understand how firms' management could be confident that the conflicts of interest associated with these different approaches and sources of revenues had been identified and could be properly managed. In our view, the ability of firms' management to identify any changes in placement patterns arising from unmitigated conflicts of interest was therefore limited.

In a number of instances, firms' management relied heavily on the belief that individual brokers acting as agent of the customer would always act in the best interests of those customers, and would evidence this accordingly on the individual customer broking files. While in many cases this may be true, firms did not appear to appreciate that this position is threatened where the individual broker's impartiality and independence could be affected by group relationships or differential remuneration structures.

It was also not clear how an individual file could present a complete picture of the placement when elements of the placement decision had been taken elsewhere in the firm (i.e. when the facility was put in place). So it was not always clear how senior management gained assurance and could demonstrate that placement decisions made as the agent of the customer were being taken in the customer's best interests.

Some firms relied heavily on principles set out in their company policies to mitigate conflicts of interest, without building appropriate procedures, controls and management information to ensure that these policies were followed. Firms' policies regarding conflicts of interest were often well articulated and sensible, but did not result in measurable outputs to demonstrate that the conflicts in the business had been identified and managed to evidence that the intermediary had consistently acted in the customer's best interests.

Tender and review processes

It was not always clear that customer needs were at the heart of the process when some intermediaries (re)negotiated underwriting capacity for SME products with insurers. In a number of cases the processes focused predominantly on the levels of remuneration available for the intermediary. This was of particular concern where the facility was managed within the broking part of the business and relevant policies were sourced or placed by the intermediary acting as agent of the customer.

In some firms there was limited or no evidence showing what had driven the decision to select a particular market to underwrite the product, and there was no audit trail supporting the decision. This contrasted markedly with other firms in our sample who could very clearly evidence both their consideration of customer needs and the decision making processes which led to a particular market being chosen.

This lack of audit trail regarding market selection can make it hard for these intermediaries to evidence why it is appropriate to use this product when placing customer risks. It also presents material additional risks to the intermediary in the event that the market chosen is unrated or offers lower security than other available options.

Example 3

We considered two tender exercises performed in 2013 by one of the intermediaries within our sample. In both examples we considered this intermediary had undertaken detailed preparatory work surrounding customer needs before starting the tender process and had then sent out a formal tender document setting out the requirements to a range of appropriate insurers, including the incumbent party.

The tender documents required the insurers' replies to separate the product offering from the proposed remuneration, so that the initial decision about the best product could be made solely based on the merits of the product and services to be offered to their clients. The firm maintained a clear audit trail (including scoring mechanism and results) of this decision making process.

Following this selection process the firm engaged with the chosen provider and negotiated the commercial terms, again with a clear audit trail, before the final conclusion of the arrangement.

Even in intermediaries where shortcomings were identified in the tender processes, relevant staff still emphasised the importance attached to providing products that met their customers' needs. In some cases these intermediaries explained that they had secured material enhancements to the insurer's standard terms and conditions. However, there was not always clear evidence surrounding the additional benefits secured or their value and impact on the price of the product. Where available, this evidence helped to support the intermediary to demonstrate that it was appropriate to advise their customers to use this product.

The extent of the review processes to consider existing insurer facilities, insurer panels and binding authorities also varied considerably among the population of intermediaries we considered. In many cases these arrangements were agreed with underwriters for a number of years and, while there were normally some processes in place to review underwriting performance, it was not always clear what (if any) equivalent processes existed to consider performance from a customer perspective. In some cases insurer arrangements used extensively by the intermediary acting as agent of the customer had been in place for several years with no available evidence that their performance and value from a customer perspective had been considered since their inception.

Example 4

One firm could not provide any evidence of review work from a customer perspective in relation to an SME affinity product it had been sourcing as agent of the customer using a single insurance market (i.e. without considering other placement options) for the previous three years.

Another intermediary group could not provide evidence of any review or tender process since 2010 in relation to a five year affinity product arrangement for a particular class of business. During this period the arrangement with the underwriter had been moved from a broking entity (acting as agent of the customer) to a new MGA within the group, with some smaller clients moving from receiving a broking service (with the broker acting as their agent) to being serviced directly by the MGA (acting as agent of the insurer).

The absence of any review processes makes it hard for intermediaries to demonstrate the basis on which they are able to continue to advise their customers to buy products or to demonstrate that these products remain competitive and suitable for the customers using these products.

The quality, regularity and formalisation of review processes also varied widely. Some were comprehensive, well evidenced and documented and occurred at regular set intervals, while in other cases these appeared ad hoc with little or no evidence as to what had been reviewed.

The need to review facilities regularly to ensure that they are the right choice for customers is particularly relevant where they are being used by an intermediary acting as the customers' agent or providing a recommendation to the customer, to ensure the product remains suitable.

In some intermediaries the responsibility for market selection clearly lies entirely with individual brokers who are able to decide where to place SME customer risks as they see fit and should evidence this on the individual customer file. However, in intermediaries where particular insurers have preferred status or are being used without other markets being considered, it is not apparent that the work performed centrally is sufficient to enable individual brokers to place customers directly to the preferred or sole provider product while continuing to meet all of their fiduciary and regulatory obligations.

Disclosure

Some firms considered in the sample relied on compliance with the ICOBS disclosure requirements (as set out in Chapter 4 of ICOBS) to address any risks arising from conflicts generated by their business and remuneration models that were not effectively mitigated by their control frameworks.

In our view, if firms initially look to disclosure to mitigate conflicts of interest arising from their business model rather than seeking to 'maintain and operate effective ….. 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' (SYSC10.1.7R and SYSC10.1.9G) it is difficult to determine how they are meeting these requirements.

Some firms were not always clear and consistent in disclosing to SME customers what work had been performed in placing their individual risks, and did not always provide customer disclosure consistent with the nature of the work that had been carried out.

Example 5

One intermediary placing customers' business to a single provider facility described this to customers via the Statement of Demands and Needs as open market broking. This was on the basis of a central annual review of policy wording showing that this product provided cover at least equivalent to competitor products.

The review considered only wording rather than pricing, and no additional comparison work was performed or other quotes sought by individual brokers prior to placing clients on this facility. This creates the risks that the customer is not receiving the service he believes he is receiving and could potentially pay more for insurance than he would do if other quotes had been sought.

The disclosure provided to customers before concluding their insurance arrangements was often very generic and unclear about the scope of the services being provided for the specific transaction. It was also not always clear whether the intermediary was acting as agent of the customer or the insurer (and therefore to whom they owed fiduciary duties) and how this varied across the range of insurances being provided. The absence of this information could make it hard for the customer to make an informed decision about the insurances being offered.

Example 6

One of the intermediary groups included in the review used a single model customer terms of business agreement (TOBA) for the large majority of their small and micro business customers. This covered a wide range of potential sourcing, placement and remuneration scenarios, including acting as agent of the customer, insurer or in a dual capacity, advised and non-advised sales, placing to insurers via other group companies including MGAs, performing an open market broking exercise, placing to a single market, using a panel, receiving profit commissions, receiving over-riders, receiving work transfer amounts from the insurer and deriving revenue from arranging premium finance.

A customer receiving this document is unlikely to be in a position to understand what work has been done for them individually, what capacity the firm has acted in and how the intermediary has been remunerated.

Customer understanding

SME customers' understanding of insurance intermediary services

The general insurance needs of SME customers are often more complex than those of retail consumers, so being able to access appropriate advice is important in terms of enabling them to secure protection against things going wrong. This was reflected in the intermediaries included in our review, who provided advice and recommendations (rather than merely information) to the large majority of their SME customers. However, our customer research suggests that many SME customers do not fully understand the role being performed by their intermediary and how this might have changed in recent years.

Many customers still perceive their intermediary as an independent advisor working as their agent and seeking quotes from a number of insurers, even where this may not be consistent with the nature of the relationship described in the disclosure that they had received.

Our customer research revealed that 68% of SME customers believe that the intermediary is working as their agent and that 82% of SME customers expect an intermediary to get quotes from more than two insurers when placing business insurance. 61% of SME customers expected an intermediary to seek quotes from at least four insurers, and 27% of SME customers expected the intermediary to obtain quotes from seven or more markets.

This was not consistent with the broking and placement processes firms had developed for many SME customers described to us in the course of the review. This was particularly apparent for micro SME customers where the intermediary may not consider it appropriate or economic to perform a broking exercise, so will sometimes place the risk directly to a product where they are acting as agent of the insurer without considering other options or insurers.

The number of SME customers exercising their rights under ICOBS 4.4 to receive full remuneration disclosure from their intermediaries remains very low, often equating to a fraction of a percentage of the number of relevant customers. This is partly driven by customer focus on overall price and a lack of interest in intermediary remuneration. This was shown in our survey, with 53% stating that they were not very concerned about the level of commission the intermediary earns from arranging insurance and a further 12% stating that they were not at all concerned. However, this may be due in part to the expectations regarding the level of commission or remuneration received by the intermediary, with 72% of SME customers expecting this to be 15% or lower.

There were also disparities between the number of such commission disclosure requests noted by the different intermediaries we met with. It was unclear whether some of these disparities could stem from a failure to recognise, centrally log and record some of these requests. Any such failure could result in a breach of ICOBS4.4, as customer-facing broking staff may not be aware of all remuneration relevant to the particular customer requesting the disclosure.

Add-on insurances, premium finance and insurances where the cost is borne by another party

Value and suitability of add-on insurances

Add-on insurances and services (including legal expenses and loss recovery) were sold by all of the intermediaries in the sample. The proportion of UK SME customers buying these products varied widely between these intermediaries, which was partly reflective of different business mixes, but also related to the extent to which the intermediary had actively sought to sell these products.

Commission rates for add-on insurances and services also varied widely, with some intermediaries earning commission levels over 50% and as high as 100%, while other intermediaries earned commission at rates much closer to that on their core products (e.g. 20-30%). In most cases there was a clear pricing structure for the sale of these products, but this was not always strictly adhered to, and in some cases this pricing structure involved materially different commission rates being charged to customers of different size for the same product.

The intermediaries involved in the review all described add-on insurance products as sold to their SME customers on an advised basis, but in some cases there was little or no documentary evidence showing what work (if any) had been done to establish the suitability of the product. It was also unclear what work had been done to establish these products' compatibility or overlap with the core products that they were being sold with. Also, in some cases no tender or review process had been carried out and evidenced, to demonstrate that the markets used for the add-on products had been chosen with regard to customer needs.

Administration fees and premium finance

Premium finance related revenues and administration fees are material contributors to revenue and profits for many intermediaries, each producing up to 7% of the total revenues generated by the intermediaries considered in our review. We published a factsheet on broker-arranged premium finance in April 2013, which reminded firms of the need to mitigate any conflicts of interest relating to this activity.[9]

Our research showed that 79% of SME customers expected intermediaries to act on their behalf to secure the best or cheapest payment option for providing premium finance, despite the fact that the majority of the intermediaries involved in our work considered that they were solely offering financing options to customers and had no duty to act on their behalf or seek the best offer.

The extent to which different intermediaries used insurer facilities to provide credit interest free or at cheaper rates than third party premium finance providers varied considerably. Intermediaries with proportionally higher premium finance revenues derived from using third party providers indicated that this was partially in response to reduced appetite from insurers to provide such credit in recent years. This experience had not been shared by those intermediaries who still had a higher proportion of their customers using insurer provided premium finance.

Some of the contracts intermediaries have in place with premium finance providers allowed the intermediary to give customers access to interest free alternatives offered by insurers, but did not explicitly deal with instances where insurers might offer cheaper arrangements that were not interest free. Some of the contracts provided for reduced rates to be offered for customers for a limited period (often one year) but did not provide for this to continue. Many of the contracts also provided material revenue and cash flow benefits to the intermediaries via advance commissions and marketing contributions. These revenues are often related to or dependent on anticipated volumes of business.

All of these examples have the potential to create conflicts of interest where there is an incentive to use that particular premium finance provider and customers may not be offered cheaper premium finance alternatives.

Intermediaries noted the customer benefits of third party premium finance both in terms of this being able to cover an entire suite of policies and the competent administration of these services by the specialist premium finance providers.

9 http://www.fca.org.uk/your-fca/documents/broker-arranged-premium-finance-plans

Most of the arrangements with premium finance providers stipulated the net rates at which they would provide the premium finance. The intermediaries were then often able to determine the gross rate charged to customers themselves, which creates a significant potential conflict of interest. The gross rates charged to customers were usually expressed either as a flat percentage of GWP or as an annual percentage rate (APR).

In most of the intermediaries a central pricing structure was in place that dictated what particular clients should be charged. However, in other cases either no formal pricing structure was in place, which allowed material variation in rates charged without clear rationale, or there was limited evidence that it was consistently adhered to.

This absence of a consistent (or any) pricing structure represents a significant unmitigated conflict of interest with individual brokers and local management having the ability to determine the amount their clients pay for premium finance (and therefore the revenues they derive from it), creating significant potential for customer detriment.

Example 7

The lack of a centrally determined and enforced pricing structure could lead to considerable divergence in the amount paid by SME customers for premium finance (even after allowing for different risk factors in the provision of finance). One of the intermediaries provided us with the following information in relation to the gross rates charged to their commercial customers:

Charge Out Rate (As a percentage of relevant GWP)	Percentage of Customers Charged Rate
0 to 3%	12.5%
3.1% to 6%	28.5%
6.1% to 9%	42%
9.1% to 12%	15%
12.1% to 15%	1.2%
Over 15%	0.8%

These charge out rates based on GWP equate to significantly higher APRs with, for example, 7.5% and 11% flat rate finance charges made in respect of 10 month financing arrangements equating to APRs of 21.6% and 32.9% respectively.

Where administration fees were charged to clients it was not always clear that there was a standard pricing structure in place, which was consistently applied. In most cases there was an articulation of what this was charged for, though the clarity with which this was communicated to the customer varied. Many intermediaries monitored penetration rates for administration fees, but these also varied significantly. Administration fees were only levied by most of the intermediaries in relation to personal lines and smaller commercial cases handled on a commission basis.

High levels of commissions noted where the end cost is borne by other parties

Certain lines of insurance (notably commercial property, residential property owners and landlords) consistently attracted very high rates of commission (generally over 35% and sometimes over 50%) given the relative lack of complexity in broking such products (which were frequently placed with a single provider or small panel).

Some of the intermediaries and insurers we spoke to expressed concerns that these commission rates exist because the customer buying the insurance product was not the business or individual ultimately bearing the cost of the product. This appears to result in some intermediaries and property owners sharing in high commission levels with the inflated costs (and any potential detriment) being borne by the underlying tenant or lessor. There is currently a Competition and Markets Authority case under way considering residential property management services, which may partially consider this issue as it affects residential properties.

3.
Our expectations and next steps

As set out in our findings, some general insurance intermediaries are not able to demonstrate that they have put in place an effective control framework and taken all reasonable steps to manage and mitigate the conflicts of interest in their business, to prevent them from potentially damaging the interests of their SME customers.

The failure to manage conflicts of interest appropriately has created risks around the placement processes in place at these intermediaries, so they are unable to demonstrate that conflicts of interest have been effectively mitigated so that placement decisions are always made in the best interests of SME customers.

We are taking the following actions as a result of our findings:

- Supervisory engagement with the firms involved in the review to address specific issues identified, using the full range of regulatory tools available to us as appropriate.
- Providing this feedback to the wider industry to illustrate potential shortcomings with existing approaches to managing and mitigating conflicts of interest.
- Engaging proactively with the industry to enhance understanding of our findings, rules and expectations, via industry forums and trade bodies.
- Providing further information and education to SME customers highlighting our findings and their rights, particularly the right to receive full commission and remuneration disclosure on request.
- Feeding our findings in to our planned work on commercial claims to ensure any issues arising from underlying conflicts of interest are identified in the course of this work.

We expect all general insurance intermediaries to reflect on how they manage the conflicts of interest arising within their business model in the context of our findings and concerns as documented within this paper, and to make any necessary changes required to ensure that they are complying with the existing regulatory requirements in this area.

4. Our existing rules and guidance on conflicts of interests

The key regulatory requirements that intermediaries need to consider (in addition to relevant common law requirements) in relation to conflicts of interest, their remuneration and disclosure are found within SYSC, PRIN and ICOBS in our Handbook.

SYSC

The whole of SYSC chapter 10 relates to conflicts of interest, but the following rules are applicable to non-common platform firms, including the insurance intermediaries considered within this thematic project.

SYSC10.1.3R
'A *firm* must take all reasonable steps to identify conflicts of interest between:

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

(2) one *client* of the *firm* and another *client*;

that arise or may arise in the course of the *firm* providing any service referred to in SYSC 10.1.1 R.'

SYSC10.1.7R
'A *firm* must maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps to prevent conflicts of interest as defined in SYSC 10.1.3 R from constituting or giving rise to a material risk of damage to the interests of its *clients*.'

SYSC10.1.8R and SYSC10.1.8AR
'1) If arrangements made by a *firm* under SYSC 10.1.7 R to manage conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to the interests of a *client* will be prevented, the *firm* must clearly disclose the general nature and/or sources of conflicts of interest to the *client* before undertaking business for the *client*.

(2) The disclosure must:

(a) be made in a *durable medium*; and

(b) include sufficient detail, taking into account the nature of the *client*, to enable that *client* to take an informed decision with respect to the service in the context of which the conflict of interest arises.

(3) This *rule* does not apply to the extent that SYSC 10.1.21 R applies.

The obligation in SYSC 10.1.8 R (2)(a) does not apply to a *firm* when carrying on *insurance mediation activity*.'

SYSC10.1.9G
'*Firms* should aim to identify and manage the conflicts of interest arising in relation to their various business lines and their *group's* activities under a comprehensive *conflicts of interest policy*. In particular, the disclosure of conflicts of interest by a *firm* should not exempt it from the obligation to maintain and operate the effective organisational and administrative arrangements under SYSC 10.1.7 R. While disclosure of specific conflicts of interest is required by SYSC 10.1.8 R, an over-reliance on disclosure without adequate consideration as to how conflicts may appropriately be managed is not permitted.'

Some of the intermediaries were unable to provide clear evidence that they were meeting their obligations under SYSC10.1.7R. This was largely because there was limited or no evidence that their systems and controls and management information had been designed to respond to the range of conflicts of interest that exist in their current business models. Examples of this identified by our review include:

- the absence of Chinese Walls around some enhanced commission arrangements
- the failure to ensure appropriate organisational controls were in place surrounding the appropriateness and frequency of tender processes
- the failure to identify significant commission differentials arising from certain insurer deals and to monitor their effect on placement activities
- the lack of effective organisational arrangements around premium finance rates charged to customers.

The firms who were not able to provide sufficient evidence that they were meeting their obligations under SYSC10.1.7R in all areas had not always identified these issues prior to our work and therefore had not made the mitigating disclosures required under SYSC10.1.8R.

PRIN

Principles 3, 6, 7 and 8 are particularly relevant when considering the issues raised above.

PRIN2.1.1R

3 Management and control	A *firm* must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
6 Customers' interests	A *firm* must pay due regard to the interests of its *customers* and treat them fairly.
7 Communications with clients	A *firm* must pay due regard to the information needs of its *clients*, and communicate information to them in a way which is clear, fair and not misleading.
8 Conflicts of interest	A *firm* must manage conflicts of interest fairly, both between itself and its *customers* and between a *customer* and another *client*.

ICOBS and BIBA guidance

ICOBS Chapter 4 details the requirements for intermediary firms' disclosure of the nature and scope of the services they provide and their remuneration. This area has also been subject to further guidance in the form of BIBA's industry guidance issued in 2009, which was confirmed by the FSA when released and then reconfirmed in 2012 for a further three years.

Firms generally appeared to have taken into account this guidance as it relates to individual ICOBS rules, with some minor exceptions. One of these exceptions is that it was unclear whether firms were always appropriately recognising and responding to requests for commission disclosure.

However, firms do not appear to have taken into account the elements of this guidance that relate to SYSC and PRIN more broadly and appear to have focused entirely on the more granular tick-box disclosure requirements at the expense of a wider consideration of their regulatory obligations to manage conflicts of interest and how these interact with their own individual business model.

The ICOBS rules address the narrower issue of disclosure and as such the broader systems and controls requirements of PRIN and SYSC also need to be taken into account and complied with.

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