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Tangled up in regulation

The changes that could tie brokers in knots

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Tale of the red tape

The increasing burden of regulation and the investigation into the sale of add-ons could make the next few years very uncomfortable for brokers, writes **Martin Friel**

It would be a stretch to say that the broking market took warmly to the regulatory world when it was introduced in 2005 but if brokers think the regulator has been over burdensome and oppressive to date, they ain't seen nothing yet, as the saying goes.

In other words, if as a broker you have managed to survive thus far without paying too much attention to regulation and compliance, you'd better start engaging with the regulator and quickly. There are a host of issues on the agenda that have the potential to cripple individual firms but also, more importantly, change the face of the market as we know it.

You will have heard of referral fees, add-ons, commission disclosure and client money and there will be an understanding that they are important. But what you may be less clear about is just how important these issues are, what they mean for your business and how you can prepare for the impact they will have.

One of the most discussed is the imminent ban on referral fees – hopefully only brokers living in a cave for the last six months will be unaware of what is happening.

It has become political mainly because the press have picked up on it and made it a consumer issue. This means it is no longer something that should have and could have been dealt with in-house. The government

sees the capital to be made from it and appears determined to ban their use.

So what does it mean for brokers? The ones that will be most reliant on referral fee income are the large personal lines brokers but they are big and ugly enough to look after themselves and deal with the fallout from this.

For smaller brokers, it really depends how dependent they are on the revenues derived from referral fees – some will be affected more than others depending on their business model. But whatever the extent of broker reliance, one thing is pretty certain – the ban is coming so they had better be preparing to replace that income in some way or other.

Facing investigation

The ban on referral fees, unfortunately, is just the beginning. What is potentially more damaging to the wider broking market is an investigation by the Office of Fair Trading (OFT) into the sale of add-ons – legal expenses, mobile phone cover, warranty extension and the like.

What is being investigated here is not necessarily the validity of the products – it is generally accepted that they have a value if appropriate to the customer – but the way in which they are sold. There is evidence that some of these products are being sold without the customer's knowledge, are inappropriate to their needs and are being sold with a

significant mark-up that is difficult to justify. What the OFT is looking at is whether these products are being sold properly. If the government body finds there is a market-wide issue then it could refer the trade in add-ons to the Competition Commission.

If this isn't enough to scare brokers, it's worth noting that the whole payment protection insurance (PPI) scandal began with an investigation by the OFT. With the widespread sale of add-ons through the broking market, this could be a huge scandal waiting to happen.

Not convinced? Well perhaps the words of compliance expert Mike Cranny will focus the mind: "This could be the PPI of broker market but it depends on what the Financial Services Authority (FSA) wants to do."

He says the FSA could insist that brokers check their sales processes and if they have not been meeting its requirements, they could force brokers to conduct a past business review of their add-on sales and recompense customers that have been mis-sold.

"They could insist brokers check every single sale of an add-on they have made since 2005," Mr Cranny warns.

That alone will cost brokers a huge amount of time and money but it is far better than the alternative of a full blown investigation by the Competition Commission. It appears that the FSA would prefer the market to get to grips with any ▶

issues itself rather than wait for new rules to be applied and enforced, but the market does not have the best track record in this respect.

Further developments

The banning of referral fees and the investigation into the sale of add-ons have the potential to make a significant impact upon broker revenue streams, but there are two other developments that could have an even greater effect on not just revenue streams but also on the way brokers do business full stop.

The first of these is mandatory commission disclosure. The threat of this is nothing new and the British Insurance Brokers' Association (Biba) has argued the case for commission disclosure on demand for several years. The FSA has, so far, agreed this is the best way forward.

But recently Biba drew the market's attention to a leaked document that indicated that as part of its review of the Insurance Mediation Directive (IMD), the European Commission will seek to impose mandatory commission disclosure upon the UK general insurance market.

Biba tends not to indulge in sensation, so for it to come out and say this is now a possibility should indicate that it is firmly on the table. Malcolm Lee, managing director of broker network TEn Insurance Services, certainly believes it is a matter of when, not if.

"This has been on the agenda since the original IMD came in," he says.

"Biba are right – the threat is real as it is certainly on the agenda of lawmakers in Brussels. Are we going to be able to resist it forever? No, I don't think so and 2019 was the date mentioned for implementation. We are going to struggle to resist it," he adds.

Although he is somewhat resigned to the belief that mandatory commission disclosure is inevitable, he is less clear about how it will be implemented, questioning how the difference between commission and recompense for work transfer will be defined.

In other words, if a broker were forced to tell a potential client that they received 30% commission from an insurer, would the client be able to appreciate how much of that was for work performed on behalf of the insurer? Probably not is Mr Lee's assertion.

He is also concerned that if brokers moved to a fee model the market would segment, with the large brokers focusing on bigger business leaving the SME segment to the remaining brokers. However, he predicts that SMEs won't pay for fees and will end up purchasing insurance without advice.

Should brokers be preparing for it? Mr Lee thinks it's a bit early for that but his broking peer, Brokerability chairman Ashwin Mistry believes the exact opposite. In fact he advises that brokers should be renewing business on a fee basis as mandatory commission disclosure is a foregone conclusion. ▶

"The threat is real as [commission disclosure] is certainly on the agenda of lawmakers in Brussels. Are we going to be able to resist it forever? No I don't think so"

Malcolm Lee, TEn Insurance Services

The broker views

● **Steve Godbold, chief operating officer, Lorica Insurance:** "Time [spent on regulatory issues] is difficult to quantify as the investment is in setting up the right systems which then pay off.

It is essential to have the right cultural mindset bearing in mind the principle-based regulation. We look at regulation as a support for business rather than a barrier. We have also made significant investment in compliance professionals to assist our growth and we expect this to continue.

We do not expect to spend more time overall on regulatory issues, just continual commitment to positive cultural messages with regards to regulation."

● **Duncan Coleman, managing director at Green Insurance Group:** "We would expect the cost of regulation to rise in that there is continually an up-scaling of rules and regulations.

The Financial Services Authority (FSA) is not so prescriptive, a lot is open to interpretation. You can speak to one consultant and get one point of view while another will give you a different point of view. It's like there's a roomful of swords hanging from the ceiling.

What's more, we seem to be the first to adopt everything that comes out of Europe in terms of rules and regulations and I think that's part of the problem. This works against us in what is a relatively low-risk business sector – as an industry it's far cleaner than it's ever been and you only have to look at recent reports from the financial ombudsman to see that.

We have to try and live with all the rules and regulations which the high street banks have to adhere to and that's disproportionate.

I do believe the cost of regulation will increase – FSA fees will be higher and there's probably going to be more to pay for the Financial Services Compensation Scheme levy.

Some of the regulations are good as they help us to run a business in a more organised fashion. We adopt a risk-based approach ourselves in everything we do because we are different to a PLC that's accountable to shareholders. It is our own money which is on the line."

● **Peter Elliot, head of marketing, Bluefin:**

"In terms of the cost of human resources, processes, systems and paperwork, it's quite a stringent regulatory regime. We do expect the cost of compliance to rise but the question is by how much and that's the bit we don't know.

We would think regulation costs us about £5m a year, although it's hard to put a precise figure on it. One way that we think about it is that as a company we have to work three weeks every year just to pay for the cost of compliance. It has increased quite considerably over the last five years although the company has changed as well during that period.

We are not expecting the cost of regulation to decrease although we are hoping it won't rise at quite such a dramatic rate.

The Financial Services Authority (FSA) has been pretty good at communicating with brokers under the Hector Sants regime. Obviously communication is a two-way street. There's also an onus on the entity being regulated to maintain dialogue with the regulator.

But I think there's a sign the FSA is trying to reach out a bit more to the broking community and improve the quality of that dialogue which for us which is very welcome – it's about frequency and clarity.

In terms of the future what we look for is fairness, Relevance and proportionality are key to a successful regime. I think all too often it's the larger brokers that come under the spot light when a lot of small firms don't seem to be under the same degree of scrutiny."

Andrew Pearce

Despite the fact that Mr Mistry says there is little demand from clients to know the commission a broker earns, he claims that as mandatory disclosure is inevitable, brokers should embrace it and use it as a differentiator. And it is, he argues, just another reason why brokers need to start behaving like businesses rather than brokers. "Why are brokers scared of it?" he asks.

"It is going to be painful but you have to get a bit more prepared. Confront your demons as it is an opportunity to differentiate yourself. Brokers need to have strong conversations with their customers and show where they add value and talk about what the clients' business costs the broker to manage."

He also feels that moving to a fee structure will free brokers from a reliance on insurer

performance – brokers would in effect finally be responsible for their own financial performance. Perhaps that is where the fear originates?

Despite the belief of some that mandatory commission disclosure is almost a foregone conclusion, it would still be some time away and there is breathing space for brokers to prepare to adapt their business models

Brokers face up to increased scrutiny



Few things have caused more shivers to run down the spines of brokers and insurers alike than the impending change to the regulator. After the Financial Services Authority's (FSA) poor handling of the risks posed by the financial services sector (in particular banking) and the public outcry that followed, the government has been desperate to be seen to be making bold decisions in this area.

Indeed, before the last general election, the Conservative party made an overhaul of the regulator part of its party manifesto. And so it came to pass that the decision was made to split the FSA into the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) – insurers coming under the supervision of both the PRA and the FCA and brokers coming under the remit of the FCA.

One of the few things we do know about the new regime is that the new regulator has promised to be more intrusive, more punitive and more interventionist, which doesn't necessarily bode well for the insurance market. The main problem is that the tone has been set to address the problems inherent in the banking sector.

Transferring this model to the insurance market may not be the most suitable option but the bad news is, tough, that's what is happening. The regulator is going to be putting a much greater emphasis on supervision and it is going to want to know a lot more about the products that are being distributed in the market, just see the add-on investigation for proof of that.

"Regulation of financial services has become a political football," says Steve White, head of compliance and training at the British Insurance Brokers' Association (Biba).

"Preventing the failures of the past rather than downward pressure on cost or style of regulation [is the main driver]."

He warns that the new focus on supervision should be the main concern for the market but there is hope in the fact that the regulator is paying closer attention to the actual risks posed.

"Our regulator has a passion and enthusiasm for supervision way beyond anything witnessed in mainland Europe. Our research last year showed that the cost of regulation in the UK is three times that of our nearest European neighbour and this cost is driven by supervision," Mr White explains.

"But the FSA is looking more closely at risk than it has done before. The Office of Fair Trading has asked the FSA to look at motor legal expenses insurance and is showing an interest in add-on products. This started in banking but has now extended into our sector."

This desire to get away from the problem of rules designed for the banking sector being applied to insurance has led Biba to attempt to influence the make-up of the new regulator but Mr White believes that much of the market's regulatory future is in its own hands.

"The [government] is in listening mode and we are starting to see a more risk-based approach to its supervision. We accept that the regulator needs

to supervise but we want to see a more appropriate and proportionate approach to this.

"The sector needs to demonstrate that it is compliant by nature and once that is accepted we should get more appropriate regulation," he believes.

This is a very pertinent point and one that the industry would do well to heed. There is a belief that the regulator would welcome an insurance industry that can, to a degree, self-regulate but the ability to do so must be apparent.

"The industry needs to have an honest discussion about things like referral fees," says David Thompson, director of policy and public affairs at the Chartered Insurance Institute.

"A responsible, engaged industry will try to sort out its own problems but that is not easy to achieve in a competitive environment. With referral fees, there was never going to be a first mover advantage but fortune favours the brave."

The regulator appears to be adopting a 'better to be safe than sorry' approach but equally there is a growing understanding that the insurance industry does not come close to banking in terms of the risks posed. It appears that if the industry could show the regulator that it can keep its house in order, then there is an appetite to loosen the apron strings and allow the market to function with lighter supervision.

But the responsibility does not lie entirely with the insurance industry. According to Mr Thompson, the regulator needs to do a better job of highlighting good practice when it sees it rather than simply focusing on the incidences of bad behaviour.

"What about the regulator acknowledging those firms that have gone beyond the minimum requirements?" he suggests.

"The FSA is trying to improve the culture of firms but it has not yet articulated how it will say what it looks like when a firm is doing well.

"It needs to find a way of acknowledging the best as an alternative to heavy duty regulation and the FCA needs to build in some way of giving signals to high standards," he adds.

There does appear to be an opportunity here. The signals coming out of the regulator at the moment are that it is willing, where appropriate, for the insurance market to sort out its own problems rather than wait for rules to be applied. Indeed, it's fair to say that the regulator has enough on its plate sorting out the banking sector.

That is not to say that the insurance industry doesn't have plenty of smouldering issues that could yet flare up into much bigger issues that will draw the wrath of the regulator. As Mr Thompson says, if the industry gets to grips with these smouldering issues, it can avoid having to deal with a burning platform situation and for now, at least, it appears there is an opportunity to show the regulator just what can be achieved with a united voice and purpose.

Martin Friel

The regulation consultant's view

● **Terence Clark, director, RWA Compliance Services:** "I don't think the broker community expects costs to drop. It's like everything else, everything is going up and regulatory costs are no different."

We have to bear in mind that over the next 18 months or so the regulatory landscape will change significantly with the introduction of the Financial Conduct Authority, Solvency II and the new Insurance Mediation Directive (IMD). This new regulation may not have in itself direct costs but indirect costs such as changes to websites and letter heads.

In terms of the Financial Services Compensation Scheme (FSCS) brokers have seen fees rocket by up to 100% and in some cases they have even trebled. Brokers are hoping there will be a review about how it's structured and that they can be separated out from the secondary sellers. At the moment everyone is classified as the same and brokers are therefore looking for new regulation to make sure those who are guilty pay their fair share.

Certainly, brokers are spending more and more time dealing with regulatory issues and less time with clients. The regulatory burden is a lot to contend with and, there's no doubt about it, it is here to stay.

But one would hope the regulator strikes upon a level which enables brokers to concentrate on running a business and making money."

Andrew Pearce

accordingly. But the final horseman of our broking apocalypse is fast approaching and, according to experts, is likely to cause widespread disruption – ladies and gentlemen, we give you client money. Or more accurately, changes to the rules governing client money.

It may be surprising that this issue is being highlighted as potentially the most disruptive to face brokers in the near future and that is partly to do with the timescales involved and the potential impact upon how brokers conduct business.

Essentially this is about broker permission to hold client money and risk transfer and the regulator is currently conducting a review in this area. According to some, the FSA has never been entirely comfortable with the idea of retail brokers holding client money and has for some time been keen to address what it sees as an anomaly.

In recent months several headline making cases of brokers mis-handling client money has justified the existence of this discomfort. But the fundamental issue lies in whether or not brokers should be holding client money at all.

"Every terms of business agreement in the country will have to be re-written and a lot of brokers will have a lot of work to do... It is going to affect every broker"

Mike Cranny, compliance expert

The problem is that in the FSA proposals for changes to the client money rules, there are a host of administrative changes that could create huge amounts of work for brokers. For instance, the regulator is proposing that brokers that do hold client money in non-statutory trusts conduct client money calculations every seven days.

As Norman Hughes, director at Compliance Management Services, explains: "One of our clients has already told us they would have to recruit another member of accounts staff to handle the extra work."

"It really calls into question the viability of continuing with non-statutory trust accounts, especially when considered in conjunction with the proposal to set a limit to the number of days' funding that will be allowed."

Administrative havoc

Another proposal is the desire to make risk transfer unconditional, a suggestion that compliance consultant Mr Cranny believes could cause administrative havoc for brokers.

"The FSA is suggesting that insurers are going to have to give risk transfer without any conditions whatsoever so they will have to give risk transfer in a precise form that the FSA will dictate or not at all."

"Every terms of business agreement (Toba) in the country will have to be re-written and a lot of brokers will have a lot of work to do," he warns.

He predicts that brokers may find that they have to hold client money as they can't get risk transfer from an insurer and as such may have to reapply for permission, a process that could take months and could restrict their ability to trade. "It is going to affect every broker," he warns.

In addition, the impact of Solvency II on insurers may make them more reluctant to give the risk transfer that many brokers need.

"A lot of brokers don't have a choice [regarding client money] as they don't have the risk transfer due to a lack of volume business as they might have a niche market," says Jill Hambley, head of compliance

technical and proposition development at UKGI.

She adds that brokers find it difficult staying within the terms of insurer Tobas and that, although they may have conducted a review of all the Tobas they have signed, these change over time, and if a broker has scores of agencies, it is difficult to ensure compliance with the risk transfer aspects of each one.

There are a host of other changes the FSA is proposing and the only way a broker is going to be able to begin to deal with them is to prepare now. There is too much detail in the proposals to relay within the confines of this feature, but all the detail can be found on the FSA website (www.fsa.gov.uk) and if the concern that the compliance experts are expressing over the proposals is anything to go by, the changes to client money rules is the big threat to the broking market in the immediate future. It may be boring, it may look like an administrative job, but ignore it at your peril.

Never mind the potential loss of income associated with referral fees and add ons – client money changes could impact your ability to trade full stop. If you're unsure about what it all means, at the very least, check the FSA website and at best invest in some professional advice. This really is the issue that could break the proverbial camel's back. ■

The insurer view

● **Michael Jones, head of group compliance, LV:**

"For brokers the cost of regulation has been rising steadily over the last decade and I don't see that changing."

Certainly, the volume of regulatory change at the moment does require a significant amount of time as we do feel that it will have a significant impact on our future. We have invested a lot of time into this debate already.

For us, if we don't work with the regulator now we will end up being landed with regulation we don't want – it's worth spending the time to make sure it's right. Indeed, I don't think the amount of time firms spend on regulatory change will ease up.

The regulator has done a good job in terms of the level of communication it has with us. From our point of view, LV has always had a good and constructive dialogue with the Financial Services Authority's (FSA) supervisors and policy team.

I think firms tend to avoid talking avoid talking to the FSA but, from my experience, the FSA has always been keen to talk directly to firms to find out their opinions rather than just communicate via trade bodies."

Andrew Pearce