

Relationship between Insurers and Sales Intermediaries

Response to the CCIR and CISRO consultation paper of June 3 2005

Submission

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INSURANCE BROKERS ASSOCIATION OF CANADA

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ABOUT IBAC

The Insurance Brokers Association of Canada (IBAC) is the national professional organization of property and casualty insurance intermediaries in Canada. It represents 11 associations across Canada, who in turn represent nearly 30,000 independent insurance brokers in almost every community in the country.

Through its permanent staff, its volunteer Board of Directors, and its special committees, one of IBAC's roles is to play a leading part in the consultation process between government and the industry. The continuous dialogue is aimed at improving the services provided by insurance intermediaries, safeguarding their service and integrity, and ensuring that society will have professional advice and freedom of choice in its selection of property and casualty insurance coverage.

In this submission, IBAC will be providing a national response only. As a national association of provincial brokers associations, we represent commonalities to all jurisdictions, and therefore will not be embarking on regional or provincial specific issues.

However, as a national voice, we believe that we are in the position to be able to bring to the attention of CCIR viewpoints and opinions that would enhance the industry as a whole.

OVERVIEW

We applaud the CCIR's effort to confirm that the Canadian property and casualty insurance industry is not guilty of the illegal acts perpetrated in the United States. We especially appreciate the conclusion that:

“No evidence of any illegal insurance related activity was found.”

This finding reaffirms the efforts that we and our member organizations have tirelessly promoted the highest level of professionalism at all levels of the industry. We are proud of our service to the Canadian insurance consumer and feel that existing law along with a highly competitive and well supervised marketplace ensures that insurance buyers are protected and well served.

There are several factors to be taken into consideration when attempting to develop new measures to enhance public confidence in the property and casualty industry:

1. Any response should only address areas where problems have arisen and where a need for further action has been shown to exist. This is the foundation of our legal system. It is one based on precedence. Current laws reflect the reality of our society and are not based in the abstract, or the possibility of some future situation occurring that today does not exist. It would be an impossible task to ask legislators to dream of every possible scenario and draft appropriate laws or regulations in the interests of preventing or punishing inappropriate behaviour.
2. It is critical that any new requirements recognize that property and casualty insurance products and life and health insurance products are essentially different. And therefore any scrutiny of the regulatory regime would have to be specific to that particular line of business:
 - P&C products are designed for the management of risk or asset protection.
 - Most life and health insurance products are designed for wealth management or asset enhancement.

In terms of product distribution, one of the primary differences is that the P&C consumer can assess the contract on an annual basis with the ability to accept or reject without penalty.

3. Any new obligations contemplated should offer benefits to consumers that justify and outweigh the additional costs. Ultimately such costs will be borne by the insurance consumer.
4. Regulators should be especially careful not to tilt the competitive playing field in favor of one segment of the insurance industry.

Consumers have local needs and requirements that their property and casualty insurance should satisfy. These vary from province to province, and even between regions within a province. Current regulation accounts for those needs and leads to provincial differences.

While we understand the basis for harmonizing regulations, we feel strongly that there continues to be a much greater advantage to the consumer for individual provincial regulation. One of the great strengths of insurance regulation in Canada has been the reflection of the differences in provincial economies in the rules and guidelines for insurance distribution. In dealing with issues relating to market confidence, we are in agreement with provincial positions that a "one size fits all" approach to regulating the industry would be a) impractical, b) costly and c) not add any confidence in the market.

The question of the independence of insurance intermediaries is straight forward; all insurance intermediaries by the very nature of the service they render are assumed to have some degree of independence by the public.

The public should be made aware whenever an intermediary is captive to one supplier.

ISSUES

1. CODIFY THE PRIORITY OF THE CLIENT'S INTEREST

Introduction

The client's interests take priority over the P&C broker's interests and should not be sacrificed to the interests of others.

In order to understand the client's interests, the P&C broker must obtain or confirm information about the needs of the client and, when making a recommendation, must reasonably ensure that any product or service offered is suitable to fulfill those needs.

The P&C broker will facilitate client purchasing decisions so that they may be made solely on the attributes of the insurance product or service offered, including the value of the services of the P&C broker. The reality is that the buying decision is not made solely on price. The lowest price does not always satisfy the needs of the consumer.

It would be erroneous to presume that the interests of brokers and customers regularly conflict and that brokers act in their own self-interest to the detriment of customers as a matter of practice.

Nothing could be further from the truth, and there is no evidence to support such a conclusion. In fact, both existing law and a highly competitive industry help ensure that insurance buyers are protected and well-served.

The insurance marketplace is remarkably competitive, and buyers have an array of options when they purchase insurance. There are approximately 35,000 licensed brokers in this country. In addition there is a wide array of direct writers, captive agents, and brokers. The fierce competition on the ground floor of the marketplace keeps brokers responsive, accountable and helps ensure that consumers are well-served.

If an insurance provider offers a buyer terms or coverage that are below par, prices that are inexplicably higher than others, or service that does not create a value proposition for the purchaser, then that buyer will move his or her business to another broker or distribution channel.

The reality is that the competitiveness of the marketplace, as well as the broker's desire to retain customers and build the brokerage's value, already motivates the broker to serve the customer well.

Discussion

Licensee candidates learn in the first chapter of pre-licensing text books (*Fundamentals of Insurance* and *Canadian Accredited Insurance Broker Program*) that utmost good faith is one of the three elements unique to a contract of insurance (the other two being insurable interest and indemnity). Within that general duty of care are specific duties that the licensee owes to both the insured and the insurer.

Although this goes without saying, many jurisdictions have voluntarily adopted various codes of conduct, codes of ethics, rules, and guidance that formally entrench this notion as a matter of public record. This evolution was not in response to deal with untoward activity, or consumer demands, or lack of confidence in the market. It was simply the reaffirmation of the core principles governing the industry and the people working in it.

Above and beyond this codification, this presumption exists at Common Law, and therefore is actionable before the courts. Jurisprudence has reaffirmed this in clear and unambiguous decisions.

Another mechanism in ensuring that the client's interest remains uppermost in the transaction is that the licensee retains the exposure for any errors and omissions.

Because of the entrenchment of this duty, a number of avenues are available to consumers should they believe that the broker is not acting professionally. Most jurisdictions have in place bodies that hear complaints, and have the right to discipline and suspend licensees. Bodies range from various councils, to ombudsmen, to a variety of Dispute Resolution Services.

IBAC's position is that there are sufficient safeguards in Canada, at all levels of the profession, that make it virtually impossible for a concerted abuse of consumers to occur. In addition to these safeguards, we are of the view that the stringent oversight of regulatory bodies in each province provides an additional safeguard that is a world leader in this area.

2. RESTRICT PERFORMANCE–LINKED BENEFITS OFFERED TO INTERMEDIARIES

The CCIR has raised the issue that it may appear "...to a reasonable, informed third party..." that these types of fees would steer the consumer to or away from specific insurers to achieve some other result that may not be in the consumers best interest.

The payment of incentive compensation is a legal and effective means of rewarding insurance professionals as well as professionals in countless other sales-oriented industries. These costs are paid by the insurer because of the value provided by the broker's ability to properly assess risk. Contingent profit sharing (CPS) arrangements have perhaps more to do with providing incentives for ongoing risk management and after-sales service as they do with the initial placing of the risk. Such arrangements serve the public good in that they take the onus away from making the sale and place it on servicing the customer over the long term.

Unlike most other industries, these fees are not paid out on a volume of sale basis. The incentive for the intermediary is not to achieve a target volume of sale, but rather for those who understand the market and whose portfolio is made up of the kind of business the insurer is trying to write. This ability to properly assess risk, benefits the consumer as well as the insurer: the insurer due to prudent front-line underwriting, and the consumer due to more appropriate and affordable policies.

Quoting from a recent study¹ dealing with intermediaries, "contingent commissions based on profitability of the business placed tend to be most important when the intermediary performs some underwriting functions or has information that the insurer cannot access directly in a cost-effective manner, especially more subjective information about the quality of the risk". Brokers perform front line information gathering to ensure that the appropriate risk is placed with the appropriate insurer.

Although contingent profit sharing makes up less than 3% of insurance policy premiums and on average is less than 2%, such payments perform a significant marketplace function and benefit all three parties in the insurance transaction.

- *Brokers* with profit-sharing agreements are motivated to perform effective front-line underwriting and risk-evaluation (functions likely to be more expensive if handled solely by the insurer). They also

¹ "The Economics of Insurance Intermediaries", Professors J. David Cummins and Neal A. Doherty, 2005
http://www.insurancejournal.com/downloads/WhartonStudy_2005.05.20.pdf

assist their clients with claim prevention by providing professional advice and local knowledge.

- *Insurers* benefit as their brokers seek better qualified and more properly priced business, and
- *Consumers* gain because of more favorable pricing and policy terms which encourages the consumer to apply risk management suited to their needs.

Although it may be argued that the root of the illegal activities in the US are linked to bid-rigging, there is no direct correlation between commission based fees, and any improper and/or criminal activity. Restricting or eliminating these types of fees could dissuade the broker from serving the aggregate interests of his clients in properly assessing risk, insurers would significantly increase their exposure to risk, and consumers would be subjected to higher pricing and policy terms that would not meet all their needs.

It is our position that restricting CPS fees would result in higher fees for the consumer, no incentive for risk management for brokers, and increased exposure to risk for the insurer.

3. ENHANCE TRANSPARENCY

The P&C broker has the responsibility to ensure that the client is fully informed of all relevant information before the client makes a decision.

The client is entitled to disclosure of the risks and benefits of the financial products being considered and information about the P&C broker's business relationships that are relevant to the transaction.

There are two aspects to disclosure and both must be satisfactorily taken into account under these principles and practices:

- (1) "product information" regarding product or service features, as well as the main risks and benefits inherent in the transaction or purchase;
- (2) "P&C broker information" regarding relationship issues which are important to the consumer.

1. Product Information:

The P&C broker must clearly describe the price, product and service for the client and the ways in which the transaction will best match the needs of the consumer.

2. P&C Broker/Business Relationship Information:

The following are excerpts from the guidelines "Principles and Practices" developed by IBAC and its member organizations with respect to the sale of products and services that the industry follows and brokers adhere to. They clarify the role and disclosure obligations for the industry.

Upon request by a client and wherever relevant to the transaction, the P&C broker must include the names of organizations or persons that are, to his or her knowledge, directly providing remuneration to the P&C broker.

Upon request by a client and where the outcome of a transaction may be influenced, the P&C broker must also disclose the relationship between the P&C broker and the firm whose product is being considered; and any relationship(s) among the firms directly involved in a transaction.

The P&C broker should also disclose any other direct or indirect relationships that are relevant to, and may have influence in, the transaction.

Upon request by a client and wherever relevant to the transaction, the P&C broker must also disclose:

- all fees payable by the client,
- the method of the P&C broker's remuneration (disclosure of specific amount is not required, but disclosure of the type of compensation is, i.e., fixed and percentage commission, salary, or other) and
- must disclose the existence of any other benefits from sales incentive programs related to the transaction

IBAC strongly believes that there is no need in the marketplace for a mandatory disclosure requirement. This would encumber the consumer with even more documents and processes in spite of the fact that a very small minority of consumers ask for these. Surveys across the industry indicate that there is no overwhelming demand from consumers for this requirement. If implemented, it

would prove cumbersome, impractical, and would in no way increase market confidence.

Our position is that the current regime is practical from the perspective of the intermediary as well as the consumer. It is cost-efficient, and it achieves the goal of preventing any conflict of interest.

CONCLUSIONS

IBAC has done a thorough assessment of the current regulatory regime throughout the country regarding the issues addressed by CCIR. We believe that these are legitimate concerns.

Our industry is not static, nor do we operate in a vacuum. We recognize that instances may arise from time to time where regulators need to act in order to correct certain activities in the marketplace. In fact we applaud changes that are aimed at correcting untoward activities; this can only benefit the consumer. However, there exists no evidence at this time of practices that undermine the confidence of consumers, or of illegal activities.

Insurance intermediaries play a vital role for both insurers and consumers. A great deal of trust is placed by consumers with their brokers in handling their insurance needs. Insurance brokers take this responsibility very seriously, and consumers should expect no less.

To summarize IBAC's position on the specific issues raised by CCIR:

1) Codify the priority of the client's interest

We are of the view that currently there are sufficient safeguards which ensure that this principle is paramount at all levels of the industry. Any legislative or regulatory requirement would create unnecessary and costly burdens both for brokers as well as consumers. This could result in potentially having two regulatory bodies policing different wordings for the same purpose.

2) Restrict performance-linked benefits offered to intermediaries

As with many other service industries, performance-linked benefits exist in the insurance brokerage industry. They are however misunderstood. This benefit does not reward the intermediary due to quantity of his/her work, but on the quality of his/her work. By this we suggest that that the incentive is not tied to the amount of business provided to one specific insurer, rather the appropriate type of business, properly researched and underwritten.

3) Enhance transparency of compensation, ownership and other financial interests

We believe that a voluntary system, adapted to individual provincial needs, is the appropriate method of handling disclosure. This regime has worked in the past and we believe is adequate in dealing with some of the concerns raised by CCIR.

In referring to the illegal activities in the U.S. the previously quoted study adds:

"...competitive abuses are possible in any industry; and the normally competitive market for property-casualty insurance should be carefully distinguished from illegal activities that occasionally occur, not only in the insurance industry but also in a wide range of other sectors."

IBAC would like to respectfully recommend that it would be inappropriate to make direct comparisons between Canada and the United States in this area. Although there are similarities between the two countries, there are also many differences, and a regulatory response in one country might not be applicable, or effective in the other. Therefore it would be unjustified to blindly follow the American lead in delving into regulatory changes for something that does not exist in Canada.

It is with this premise that we strongly believe that the current regulatory framework in Canada is one that provides consumers with a transparent insurance brokerage industry, a stringent and effective oversight mechanism, and a stable and competitive marketplace which Canadians have confidence in.