



Intermediaries

Rodney Lester

PRIMER SERIES ON INSURANCE
ISSUE 10, JUNE 2009

NON-BANK FINANCIAL
INSTITUTIONS GROUP

GLOBAL CAPITAL MARKETS
DEVELOPMENT DEPARTMENT

FINANCIAL AND PRIVATE SECTOR
DEVELOPMENT VICE PRESIDENCY



THE WORLD BANK

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THIS ISSUE

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The *Primer Series on Insurance* provides a summary overview of how the insurance industry works, the main challenges of supervision, and key product areas. The series is intended for policymakers, governmental officials, and financial sector generalists who are involved with the insurance sector. The monthly primer series, launched in February 2009 by the World Bank's Insurance Program, is written in a straightforward, non-technical style to share concepts and lessons about insurance with a broad community of non-specialists.

The Non-Bank Financial Institutions Group in the Global Capital Markets Development Department aims to promote the healthy development of insurance, housing finance, and pension markets, and to expand access to a broad spectrum of financial services among the poor. These markets provide opportunities for household investment and long-term savings, and can buffer the poor against the risks of sickness, loss of breadwinner, catastrophic events, and other misfortunes.

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Abbreviations & Acronyms

ACLI	American Council of Life Insurers
CPD	Continuous Professional Development
FATF	Financial Action Task Force
FinCEN	Financial Crimes Enforcement Network (US Treasury)
FSA	Financial Services Authority (UK)
IAIS	International Association of Insurance Supervisors
KYC	Know your customer

Overview of insurance intermediation

Rodney Lester

The distribution of insurance is handled in a number of ways. The main channels include direct sales by insurance companies, agents and brokers (known generically as intermediaries), banks (bank-assurance), financial planners and various types of consumer durable and service retailers. The dominating channels show a great deal of variation across countries. For example bank-assurance now accounts for more than 50% of life insurance sales in France, Spain and Italy, whilst intermediaries dominate in most other markets.

Not enough research has been carried out on insurance intermediation but in economic terms it is clear that insurance intermediation can be classified as a market-making function and also fulfils an agency role in a principal/agent context. In the former case, the intermediary acts as a conduit between consumers of insurance and the insurers and, in the latter, the intermediary can be an agent relative to both the consumer and the insurer. Cummins and Doherty have defined intermediaries as follows:

‘... an individual or business firm, with some degree of independence from the insurer, which stands between the buyer and seller of insurance. (1) The degree of independence of insurance intermediaries varies considerably. Probably the lowest level of independence occurs when insurers use exclusive agents, who usually are independent contractors rather than employees but represent only one company. (2) Next on the scale of independence are independent agents and brokers, who regularly deal with several insurers.’

In general, large multinational businesses almost always use regional and international brokers, who provide a wide range of

services including, but not limited to, loss control, risk modelling, the establishment and running of captive insurers and risk syndication. Households, on the other hand, tend to use tied or independent agents or banks, and small to medium-size businesses tend to employ local independent agents or brokers.

There are two primary mechanisms by which insurance intermediaries can be compensated:

- A fee system under which the client directly pays for the services provided;
- A commission system under which the intermediary is remunerated based on a percentage of the premium paid by the client for coverage based upon the intermediary's agreement with the carrier.

As an element of reference, during the year 2004 commissions (brokerage) accounted for approximately 73% of revenues, while fees for services represented 12% for the top 10 international brokers. For the US non life sector, premium-based commissions varied between 21.5% for fidelity and 3.9% for medical malpractice. Income contingent upon such metrics as profitability and volume added between 1% and 2% of premiums to intermediary revenues (Cummins¹). For a regular premium life insurance policy, commissions are usually a significant proportion of the first year's premium, with 'trailer' commissions being paid in subsequent years contingent upon the persistency of premium payments. Life commission structures vary considerably but the continued recognition of zero cash surrender values in the first 2 years of a life policy in the insurance laws of many developing and transition markets points to the impact of heavy initial marketing and selling costs (see Box 1).

While commission dominates insurance remuneration structures in the early and intermediate stages of insurance market growth, there is a steady trend towards fees for financial advisers providing life cycle planning to individuals, and for large commercial and industrial non life accounts where risk management advice is a key component of the service package.

It also needs to be acknowledged that while the insurance industry around the world has experienced significant growth using commission based remuneration systems, considerable thought must be given to strategies that would possibly promote a better balance between the interests of intermediaries and consumers. For example, life insurance

1. Cummins, J., Doherty, N. The economics of insurance intermediaries. *Journal of Risk and Insurance*, March 2007

Box 1: The economics of traditional life agency systems

Life insurers have a long history of attempting to identify in advance people who would make successful agents and financial advisors. Many tests have been developed but trial and error continues to be the most effective approach in developing and transition markets. A rule of thumb in the life insurance business during the height of the traditional agency approach in a number of industrial countries (including Australia², New Zealand and the UK), was that if an agent survived four years they would become a success: less than one in eight typically made it. Thus, a life insurer using a traditional agency system typically has a large investment in a successful agent because this individual's production has to cover the costs of the failed recruits.

In this environment the natural temptation for other life insurers is to poach the proven individuals. Common approaches to countering this include guaranteeing a generous capital value for an agent's book of business when they retire, the use of contingent commissions (particularly volume over-rides) to align insurer and agent objectives, and to apply numerous positive psychological feedback systems including public recognition within the organization through awards, conferences and access to senior management.

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2. As a guide to one ultimate industry structure Australia's life intermediaries have been largely rationalized in the last 25 years and the industry is now dominated by a smaller number of financial advisors. It is planned that commissions on new business for financial advisors will be phased out by 2012. The sector is lobbying for financial advice fees to become tax deductible.

selling in the form of pyramidal multi-layer arrangements whereby friends and family (many times non-professional and unauthorized intermediaries) are induced to participate as agents for the purposes of selling within their social networks—who, in turn, may also become agents—can turn out to be a particularly egregious form of commission-based remuneration. This has been most prevalent in the late nineties in Eastern Europe, although often initiated by multi-level sales companies based in Western Europe³. The argument for such an approach is that it is the fastest way of penetrating a new market. However, lapse rates are typically high and meeting basic needs tends to be a secondary concern to generating volume. US state insurance codes contain specific wording to pre-empt such agency structures from developing (Annex 1).

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3. Policy statement—nature and consequences of pyramid activities in life and accident insurance. Commission on Financial Services and Insurance, May 1997

Legal approaches to intermediaries

Most insurance legislation around the world has some reference to intermediaries. For example, the Czech Republic in implementing the EU Mediation Directive has adopted the following definition of intermediary:

An insurance intermediary is ‘a legal or natural person who, for remuneration, pursues insurance mediation.’ Insurance mediation includes:

1. submitting proposals for the conclusion of insurance or reinsurance contracts
2. carrying out preparatory work to the conclusion of insurance or reinsurance contracts
3. concluding of insurance or reinsurance contracts on behalf of and on the account of an insurance or reinsurance undertaking for which such activity is carried on, or
4. assisting in the administration of insurance and in settlement of claims from insurance or reinsurance contracts.⁴

At the very least, insurance laws usually refer to the registration of insurance brokers, and in some countries there may be no reference at all to agents. At the other extreme, the activities of an insurance intermediary may be deconstructed where each function can be identified as a broking or agency activity, sometimes leading to the functional cohabitation in the roles of brokers and agents (e.g. Slovakia).

The difference between a broker and an agent is conceptually straightforward. A broker acts for the client. He or she should carry out a proper analysis of the client’s needs, then survey the insurance market to find the combination of products and services that best meet these needs. An agent, on the other hand, acts for one insurer (or one insurer per product line) and is basically in a selling mode. It is important to note that, despite the broker’s role of representing the client’s interest, it is common practice that commissions be paid by insurers and not the consumer, being their activity an important element in the insurance distribution costs. It also may occur that brokers select among a sufficient number of underwriters, based on ratings, quality of service, flexibility, capacity, and policy conditions, among others, to provide best possible results and efficient service to their clients. Agents will sometimes be associated with a full financial advisory service, and can act for more than one insurer offering a given product line—in

4. From the Czech Act on Insurance Intermediaries and Loss Adjusters, December 2003.

which case they occupy a half way house known as a multi or general agent. An agent that maintains an exclusive relationship with one insurer for a given product is usually known as a 'tied' or 'sole' agent⁵.

Most regulation on intermediation follows the activity-based IAIS model.

ICP 24 Intermediaries

The supervisory authority sets requirements, directly or through the supervision of insurers, for the conduct of intermediaries.

In many insurance markets, intermediaries serve as important distribution channels of insurance. They provide the interface between consumers and the insurer. Their good conduct is essential to protect consumers and promote confidence in insurance markets. For this reason, intermediaries should be directly or indirectly supervised. Where intermediaries are supervised directly, then the supervisory authority should be able to conduct on-site inspection when needed.

The World Federation of Insurance Intermediaries (WFII) has elaborated on this IAIS theme:

A. Regulation and Legislation:

A.1 Regulation /Legislation on insurance intermediation should be activity-based. The rules should be applicable to all those who are undertaking the activity of insurance intermediation. In this respect, the regulation and legislation should create a competitive level playing field between all forms of insurance distribution.

A.2 Regulations should focus on ensuring that all those who are undertaking the activity of insurance intermediation meet reasonable professional requirements as the primary means of protecting consumers and clients.

A.3 Standards, requirements and codes of conduct need to be promulgated with consultation, full documentation and accessibility by all market participants.

A.4 Regulation and legislation should be transparent and fair.

A.5 Laws and regulations should permit foreign legal and natural persons the opportunity to establish as an intermediary in the country and expand an activity as an insurance intermediary under the same conditions as nationals. Countries should allow both foreign and

5. A somewhat different agency type, common in the United States, is an agent that distributes for and manages the local operations of an insurer. These are known as managing general agents.

national insurance intermediaries options with respect to its form of establishment.

B. Code of Conduct:

WFII encourages trade associations and interested parties to develop a code of conduct. Such a code can be considered as a complement to regulation and legislation and is critical to public confidence in the industry. It will also improve or clarify the relationship between the insurer, intermediary and consumer/customer and strengthen consumer confidence and protection. A code of conduct can also improve fair competition and protect the integrity of the market.

The World Bank has also developed a good practices benchmark for insurance intermediaries as part of its Financial Sector Consumer Protection Assessment Program—Box 2.

In civil code countries the regulation of insurance intermediaries is usually included in the civil code itself or in the general contracts law (law on obligations) if separate, and often supplemented by articles in the insurance law. Common law and mixed approach countries generally rely on the insurance law or code although some countries (e.g. Australia, the Czech Republic) have enacted specialist insurance agent and broker statutes.

In the two largest insurance markets, where supervision operates at the local level under harmonized model laws (US) and Directives (EU), we see somewhat different approaches, although they are broadly consistent with the three regulatory frameworks mentioned above. The US model law is rules-based and is largely concerned with ensuring that a professional insurance intermediary vocation is developed. It accordingly has a strong emphasis on registration, training, and sanctions. The EU Directive (2002/92/EC)⁶, on the other hand, is largely principles based and more concerned with defining who is and is not an insurance intermediary, as well as providing corresponding categories. Professional requirements in the EU are very broadly defined (i.e. must be appropriate to the product complexity) and left to the member states to elucidate. Handling of monies is also covered but relevant local legislation can choose from a range of options listed in the Directive (Annex II).

⁶ See <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32002L0092:EN:HTML>

Box 2: Sales Practices

- a. All insurance intermediaries should be licensed and proof of licensing should be readily available to the general public, including through the internet.
- b. Sales personnel and intermediaries selling and advising on insurance contracts should have sufficient qualifications, depending on the complexities of the products they sell.
- c. Educational requirements for intermediaries selling long term savings and investment insurance products should be specified, or at least approved, by the Regulator or Supervisor.
- d. The sales intermediary or officer should be required to obtain sufficient information about the consumer to ensure an appropriate product is offered. Formal 'fact finds' should be specified for long term savings and investment products and they should be retained and be available for inspection for at least 7 years.
- e. Insurers should be held responsible for product related information provided to consumers by their agents (i.e. those intermediaries acting for the insurer).
- f. The consumer should be made aware of whether the intermediary selling them an insurance contract (known as a policy) is acting for them or for the insurer (i.e. in the latter case they have an agency agreement with the insurer).
- g. If the intermediary is a broker (i.e. acting on behalf of the consumer) then the consumer should be advised at the time of initial contact with the intermediary if commission will be paid by the underwriting insurer. The consumer should have the right to require disclosure of commission paid to an intermediary for long term savings contracts. The consumer should always be advised of the amount of commission paid on single premium investment contracts.
- h. An intermediary should not be allowed to identically fill broking and agency roles for a given general class of insurance (i.e. life and disability, health, general insurance, credit insurance).
- i. There must be a reasonable cooling-off period associated with any traditional investment or long term life savings contract, after the policy information is delivered, to deal with possible high pressure selling and mis-selling.
- j. Sanctions, including meaningful fines and, in the case of intermediaries, loss of license, should apply for breach of any of the above provisions.

Core regulatory issues*Definition*

A wide range of individuals (natural persons) and businesses (legal persons) fall under the generic definitions of intermediary provided

above. However, many of these, with primary activities of a different nature, may also engage in insurance related functions, thus acting as intermediaries. For example, a travel agent may issue short term travel insurance to its customers. The challenge, from a consumer protection perspective, and in order to create a level playing field, is for the regulation to be activity-based and thus include, a-priori, all those who are carrying out an insurance intermediation role. A consumer who buys short-term travel insurance (just to mention one example) needs to be sufficiently protected and, therefore, some rules -in a proportionate way- need to guarantee that the travel agent complies with minimum requirements that qualify him or her accordingly.

Modern mediation regulation is thus activity-based and thus seeks to include all insurance intermediaries. Only a few exemptions are allowed and then under very strict conditions. In the EU Mediation Directive, for example, the following accumulated conditions must be met in order to be exempt⁷:

“This Directive shall not apply to persons providing mediation services for insurance contracts if all the following conditions are met:

- (a) the insurance contract only requires knowledge of the insurance cover that is provided;
- (b) the insurance contract is not a life assurance contract;
- (c) the insurance contract does not cover any liability risks;
- (d) the principal professional activity of the person is other than insurance mediation;
- (e) the insurance is complementary to the product or service supplied by any provider, where such insurance covers:(i) the risk of breakdown, loss of or damage to goods supplied by that provider, or; (ii) damage to or loss of baggage and other risks linked to the travel booked with that provider, even if the insurance covers life assurance or liability risks, provided that the cover is ancillary to the main cover for the risks linked to that travel;
- (f) the amount of the annual premium does not exceed EUR 500 and the total duration of the insurance contract, including any renewals, does not exceed five years.”

In the USA, salaried insurance sector staff who are not primarily engaged in selling or soliciting applications for insurance are typically excluded from the definition of intermediary, as are individuals who refer potential customers to an agent, unless they actually discuss the

7. It should be noted that in some member states of the EU these exemptions are even narrower.

policy terms with that person⁸. The US code defines an agent in the following terms:

- a. solicits insurance on behalf of the insurer;
- b. receives or transmits other than on the person's own behalf an application for insurance or an insurance policy to or from the insurer;
- c. advertises or otherwise gives notice that the person will receive or transmit an application for insurance or an insurance policy;
- d. receives or transmits an insurance policy of the insurer;
- e. examines or inspects a risk;
- f. receives, collects, or transmits an insurance premium;
- g. makes or forwards a diagram of a building;
- h. takes any other action in the making or consummation of an insurance contract for or with the insurer other than on the person's own behalf; or
- i. examines into, adjusts, or aids in adjusting a loss for or on behalf of the insurer.

In addition, an intermediary in the USA is classed as the insurer's agent under all circumstances of dispute if they 'solicit an application for life, accident, or health insurance or property or casualty insurance ...'. In this regard, if an intermediary arranges insurance with an insurer before that insurer is locally licensed, the intermediary would be personally responsible for any claims that would arise.

Another issue that sometimes arises is the treatment of sub agents or other intermediaries that do not carry out the more complex advisory activities of an agent or broker. These may be family members who are appointed so as to spread income for tax purposes but have a limited role in practice. In others cases they may be spotters/ solicitors or more junior staff interfacing with customers in an agency company's or corporate broker's office. The usual approach in this situation is to require that an insurer or a fully licensed agent take legal responsibility for the actions of such individuals, who nevertheless must be licensed to sell the products with which they are involved. This same approach has been applied to intermediaries selling Microinsurance in Mexico where the responsibility of the intermediaries is borne by the insurer.

In some countries there is also a class of apprentice agent—called temporary agents in the US. This category is prone to abuse and clear and enforceable rules are required. In particular such agents must be

8. The Texas Code has been used for the purposes of this primer—<http://tlo2.tlc.state.tx.us/statutes/in.toc.htm>

required to satisfy the professional requirements of a fully licensed agent within a relatively short specified time frame (also see Annex I).

Registration

Consumers need to be able to confirm that an intermediary has acquired necessary levels of competency and is of good character. This is usually accomplished by requiring registration with, or licensing by, the insurance supervisor and the storage of related data on a central database that can be accessed by the general public through the internet.

License applications are generally in a standardized format and may include identification requirements such as a photograph or biometric information. Typical preconditions for the issuance of a license include:

- Has attained a minimum age (18 in Texas, 21 in Malaysia)
- Has satisfied the minimum educational requirement—which often includes an examination—in the recent past
- Has submitted full required documentation and fees
- Has at least one qualified officer if a company or partnership
- Has been able to arrange required levels of professional indemnity (or errors and omissions) insurance with an acceptable insurer
- Satisfies specified financial security requirements—sometimes through a bond
- Satisfies fit and proper requirements all those able to exercise control over the organization. These usually specify as a minimum no criminal record and no history of bankruptcy

In the case of tied agents there is sometimes an exception to the requirement to register/ be licensed. In these cases the agent must be registered with a licensed insurer or a recognized insurance association. However the public should still be able to check the bona fides of the intermediary and, as a general rule, it is easier to maintain one centralized register in each jurisdiction. Where companies are involved, the names of the licensed officers (approved persons in the UK) of the intermediary firm must be disclosed.

Intermediary law also usually has provisions to ensure that registries are kept up to date, including notification by means of a standard form when an intermediary ceases to be registered for any reason.

Professionalism

Insurance is usually purchased for one of three reasons—to cover important assets and related income, to protect against legal liability or for life cycle reasons (family protection, mortgage protection, education, retirement etc). These needs and the relevant products cover an enormous spectrum of exposures that range from basic commodity (e.g. motor insurance) to very complex (e.g. investment linked life insurance contracts with embedded guarantees).

Aligned with the above, the skills required of insurance intermediaries also vary dramatically depending on whether they are selling standard high volume contracts or helping customers deal with fully fledged financial planning issues. Again, we see examples of this being attacked in somewhat different manners. Annex III lists the range of insurance licenses available in California, which is specific to intermediary type, while Annex IV lays out recent thinking by the UK's Financial Services Authority (FSA) which points more to the complexity of the advice required.

Given the challenges inherent in recruiting, training and proving agents, insurers may understandably not be anxious to increase the difficulty and investment related with developing successful intermediaries. In consequence, a simplified multi level approach has begun to appear in a number of emerging markets, with insurers taking full responsibility for base level training. In addition, if an individual already has advanced and developed well accepted insurance qualifications, or a long history in the sector, they may be eligible for exemptions and grandfathering. Most countries delegate more advanced training to the insurance sector (sometimes working through an insurance institute or equivalent) or approved educational institutions. Sometimes the supervisor will also set and examine intermediaries, particularly if they intend to become involved in more complex long term products and related needs. The three basic components of any such training are typically product knowledge, the relevant laws and regulations and the ethical and professional requirements of an insurance intermediary.

As with a number of other professions, insurance intermediaries are increasingly required to undertake continuing professional education or CPD. Consistent with proportionality principles, the number of CPD hours typically varies with the complexity of the product range that the intermediary is handling. For example under the Texas Insurance Code a holder of a full license must complete 15 hours of CPD annually (at least half in a class room setting) while those holding limited licenses need only complete 5 hours.

Interaction with Customers

The interaction of intermediaries with consumers is usually regulated under four headings—correct identification and remuneration, the handling of money, information flows and confidentiality, and cooling off after high pressure sales.

Correct identification and remuneration—the customer needs to know whether the intermediary is acting for them or for the insurer. Some countries require a broker to include the word ‘broker’ in their business name; however, as noted above this is no guarantee that the intermediary is actually doing their best for the consumer. Thus the EU Directive requires a specific statement to be provided as to the capacity in which the intermediary is operating (Art 12):

‘Information provided by the insurance intermediary:

1. Prior to the conclusion of any initial insurance contract, and, if necessary, upon amendment or renewal thereof, an insurance intermediary shall provide the customer with at least the following information:
 - (a) his identity and address;
 - (b) the register in which he has been included and the means for verifying that he has been registered;
 - (c) whether he has a holding, direct or indirect, representing more than 10 % of the voting rights or of the capital in a given insurance undertaking;
 - (d) whether a given insurance undertaking or parent undertaking of a given insurance undertaking has a holding, direct or indirect, representing more than 10 % of the voting rights or of the capital in the insurance intermediary; ...

In addition, an insurance intermediary shall inform the customer, concerning the contract that is provided, whether:

- (i) he gives advice based on the obligation ... to provide a fair analysis, or
- (ii) he is under a contractual obligation to conduct insurance mediation business exclusively with one or more insurance undertakings. In that case, he shall, at the customer’s request provide the names of those insurance undertakings, or
- (iii) he is not under a contractual obligation to conduct insurance mediation business exclusively with one or more insurance undertakings and does not give advice ... to provide a fair analysis. In that case, he shall, at the customer’s request provide the

names of the insurance undertakings with which he may and does conduct business.

In those cases where information is to be provided solely at the customer's request, the customer shall be informed that he has the right to request such information.⁷

If the intermediary is acting for the consumer then the consumer also has a right to know if the insurer will be paying commission to that intermediary or an associated entity. In some countries this is a discretionary question that the consumer may ask, but good practice would require the broker to advise his or her client in all cases if commission will be paid.

In some markets it is illegal for intermediaries to rebate commission. Industry should be encouraged to inform the client when fees and commissions are paid for the same transaction.

Handling of money—brokers and agents in some markets, and under strictly regulated circumstances, may collect the initial premium under a long term (i.e. life) contract, and sometimes senior agents and brokers handle both renewal premiums and claims moneys on behalf of their clients. In some jurisdictions, it may be common practice for both agents and brokers, and for the laws to specify, that once premium moneys have been received by them, then the moneys are deemed to have been received by the relevant insurer. In other countries, such as Australia, insurers have an incentive to enforce collections because premium receivables more than 90 days aged are not included as permitted assets for solvency purposes. Despite this, brokers sometimes may rely on investment income on the 'float'—particularly when interest rates are high—to supplement their income.

Brokers in some jurisdictions are required to maintain completely separate bank accounts and accounting records for all client moneys, although, unlike agents, they may deduct commissions in advance. Agents tend to be paid according to a regular cycle with full statements provided showing allowances for discontinuances, adjustment and refunds, as well as new business and renewals. In addition, brokers and independent agents handling client moneys are sometimes required to maintain bonds or other 'financial capacity' equal to a proportion of total annual premium turnover (also see Annex II).

Information flows and confidentiality—aside from information as to the status under which they are operating, the intermediary, if an agent, is normally required in more advanced markets to identify the insurers for which it is selling. All intermediaries are also normally required to disclose the location of the register of intermediaries and how the customer may file complaints. This information normally has

to be transmitted in a recordable form, as defined for example in the EU Mediation Directive:

‘Information conditions

1. All information to be provided to customers in accordance with Article 12 shall be communicated:
 - (a) on paper or on any other durable medium available and accessible to the customer;
 - (b) in a clear and accurate manner, comprehensible to the customer;
 - (c) in an official language of the Member State of the commitment or in any other language agreed by the parties.
2. By way of derogation from paragraph 1(a), the information referred to in Article 12 may be provided orally where the customer requests it, or where immediate cover is necessary. In those cases, the information shall be provided to the customer in accordance with paragraph 1 immediately after the conclusion of the insurance contract.
3. In the case of telephone selling, the prior information given to the customer shall be in accordance with Community rules applicable to the distance marketing of consumer financial services. Moreover, information shall be provided to the customer in accordance with paragraph 1 immediately after the conclusion of the insurance contract.’

In Texas the complaints system is notified with the policy document:

- (A) Each insurance policy delivered or issued for delivery in this state shall include with the policy a brief written notice that includes:
 - i. a suggested procedure to be followed by a policyholder with a dispute concerning the policyholder’s claim or premium;
 - ii. the department’s name and address; and
 - iii. the department’s toll-free telephone number.
- (B) The commissioner shall adopt appropriate wording for the notice.’

In the most advanced markets intermediaries dealing with the general public are also required to obtain sufficient information from the client to ensure that the product being provided is appropriate and to transmit the information in a tangible manner. The relevant wording from the EU Directive is as follows:

Prior to the conclusion of any specific contract, the insurance intermediary shall at least specify, in particular on the basis of information provided by the customer, the demands and the needs of that customer as well as the underlying reasons for any advice given to the customer on a given insurance product. These details shall be modulated according to the complexity of the insurance contract being proposed.⁹

Cooling off—where long term commitments such as long term savings or investment products are involved, consumers may regret having entered into a contract if high pressure selling, multi-level selling through friends or family, or distance telephone sales were involved. For this reason, many countries now require that a cooling off period be incorporated into the policy wording. During this period the consumer has the right to nullify the transaction. Cooling off periods (also known as free look periods) are seen primarily as a consumer protection mechanism, although it has been argued that they are also economically efficient¹⁰.

The right of withdrawal is enshrined in Art 6 of the Distance Marketing of Financial Services Directive. According to the provisions, the consumer has the right to withdraw from a contract without penalty and without giving any reasons. The periods vary with product and are longer for insurance contracts and pension products. The period of withdrawal typically begins with the conclusion of the contract and would normally be in the range of two weeks (14 calendar days as stated in the aforementioned directive). The EU Life Insurance Consolidated Directive specifies a cooling off period of between 14 and 30 days after the 'contract has been concluded'.

Cooling off periods are not uncommon for long term insurance products (i.e. life insurance); you may see them in other developed markets such as Singapore and can observe that they could cover a relatively wide range of insurance products in countries such as Australia: (see <http://www.asic.gov.au/fido/fido.nsf/byheadline/Cooling+off+rights?openDocument>).

Typically, these cooling off periods would be longer than those used in securities (including investment linked life contracts) because of the onerous early termination penalties that apply to many traditional

9. The UK has perhaps taken this the furthest by pioneering know your customer KYC concepts (see for example http://www.fsa.gov.uk/pubs/cp/cp06_19.pdf Ch14). It defines KYC (in the consumer protection as opposed to the money laundering sense) as follows: Know your customer. When advising customers, KYC is also known as 'factfinding'. It refers to obtaining sufficient information about a customer's personal and financial situation before giving the advice.

10. Rekaiti, P. and Van den Bergh, R. 'Cooling-Off Periods in the Consumer Laws of the EC Member States. A Comparative Law and Economics Approach', *Journal of Consumer Policy*, Nov. 2004

life insurance savings contracts. In countries like Japan, for example, certain products such as variable annuities have cooling off periods incorporated into their product designs.

Intermediary laws sometimes require agents and brokers to secure customer information and to treat it as confidential. However, we observe this may not often be contemplated sufficiently, and hence, needs closer attention.

Sanctions

In some industrial and transition countries, acting as an intermediary while not licensed normally attracts criminal charges under the insurance law or agency law and may be sanctioned by fine or imprisonment. Embezzlement and fraud are handled in the same manner as other instances of theft. These events, plus the following also normally lead to revocation or suspension of license:

- Intentional misstatement on licence application
- Material misrepresentation of the terms of an insurance contract
- Making untrue or incomplete comparisons with other insurers' product terms and conditions so as to encourage surrender (in the case of a life contract) and switching
- Has rebated commission
- Has been convicted of a felony
- Has only obtained the license to sell insurance to family, friends and associates

Lesser sanctions can include placing the intermediary on probation and issuing a public reprimand.

Anti money laundering

Anti money laundering and preventing funds from reaching terrorists are now major concerns for financial institutions. Know your customer (or KYC) standards must be implemented by the national supervisory authorities, whereby financial institutions have different degrees of freedom to design their own customer acceptance policies. The key elements of the policy as it relates to the insurance sector can be found in IAIS ICP No. 28—Anti Money Laundering, Combating the Financing of Terrorism, which specifically acknowledges the role of the Financial Action Task Force on Money Laundering (FATF). FATF

has issued the basic document on anti money laundering known as the Forty Recommendations (http://www.fatf-gafi.org/document/28/0,2340,en_32250379_32236930_33658140_1_1_1_1,00.html).

A number of the major London based international insurance and reinsurance brokers, for example, are known to have installed comprehensive internal surveillance systems, but most responsibility lies under the law with the insurers and their bankers. In the US, the Patriot Act covers the potential for the insurance sector to be used as a vehicle for money laundering or terrorist financing and, here again, primary responsibility lies with the insurers. However, the US Treasury has made it clear that intermediaries have a role to play, as noted by the American Council of Life Insurers (see Annex V).

Annex I—US approach to ensuring only professional agents are licensed

Sec. 4001.104. ISSUANCE OF LICENSE: INTENT TO ACTIVELY ENGAGE IN BUSINESS OF INSURANCE FOR GENERAL PUBLIC.

- (a) The department may not issue a license as an agent to write any line of insurance unless the department determines that:
 - 1. the applicant is or intends to be actively engaged in the soliciting or writing of insurance for the general public and is to be actively engaged in the business of insurance; and
 - 2. the application is not made to evade the laws against rebating and discrimination, either for the applicant or for another person.
- (b) This subchapter does not prohibit an applicant from insuring property that the applicant owns or in which the applicant has an interest. It is the intent of this subchapter to prohibit coercion of insurance and to preserve to each individual the right to choose that individual's own agent or insurer and to prohibit the licensing of an applicant to engage in the business of insurance principally to handle business that the applicant controls only through ownership, mortgage, sale, family relationship, or employment. An applicant for an original license must have a bona fide intention to engage in business in which, in any calendar year, at least 25 percent of the total volume of premiums is derived from persons other than the applicant and from property other than that on which the applicant controls the placing of insurance through ownership, mortgage, sale, family relationship, or employment.
- (c) The department may not deny a license application solely on the ground that the applicant will act only part-time as an agent.

Annex II—Securing policyholder moneys: EU options

Member States shall take all necessary measures to protect customers against the inability of the insurance intermediary to transfer the premium to the insurance undertaking or to transfer the amount of claim or return premium to the insured.

Such measures shall take any one or more of the following forms:

- (a) provisions laid down by law or contract whereby monies paid by the customer to the intermediary are treated as having been paid to the undertaking, whereas monies paid by the undertaking to the intermediary are not treated as having been paid to the customer until the customer actually receives them;
- (b) a requirement for insurance intermediaries to have financial capacity amounting, on a permanent basis, to 4 % of the sum of annual premiums received, subject to a minimum of EUR 15000;
- (c) a requirement that customers' monies shall be transferred via strictly segregated client accounts and that these accounts shall not be used to reimburse other creditors in the event of bankruptcy;
- (d) a requirement that a guarantee fund be set up.

Annex III—California insurance licenses

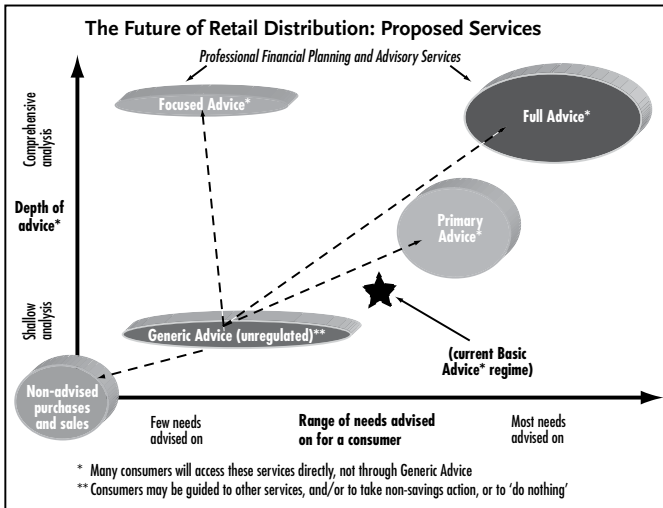
License Classes Listed in Alphabetical Order

Accident and Health Agent
Administrator
Bail Agent
Bail Permittee
Bail Solicitor
Cargo Shippers' Agent
Communications Equipment Insurance Agent
Credit Insurance Agent
Fire and Casualty Broker-Agent
Insurance Adjuster
Interim Public Insurance Adjuster
Life Agent (Life-Only Agent, Accident and Health Agent)
Life and Disability Insurance Analyst
Life-Limited To The Payment of Funeral And Burial Expenses
Life-Only Agent
Limited Lines Automobile Insurance Agent
Motor Club
Part-Time Fraternal Agent
Personal Lines Broker-Agent
Public Insurance Adjuster
Reinsurance Intermediary-Broker/ Intermediary-Manager
Rental Car Agent Licensing
Self-Service Storage Agent
Surplus Line Broker
Special Lines' Surplus Line Broker

Stock Agent
Title Marketing Representative
Travel Agent
Vehicle Service Contract Provider
Viatical Settlement Licenses *

* These licenses are issued by the California Department of Insurance's Legal Division

Annex IV—The future of retail distribution according to the UK financial services authority



This diagram illustrates the difference between:

- Full advice, which should cover the full range of needs in depth;
- Focussed advice, which is narrow in terms of the range of needs considered, but involves deep analysis of the needs within that range;

- Primary advice, which is intended to cover a substantial range of savings (and possibly, protection) needs but with limited analysis of those needs in determining product recommendations;
- Generic advice, which is likely to be personalized but unregulated in terms of the Financial services and Markets Act 2000 (FSMA), giving help and guidance for consumers on their financial needs ... it may be very limited in terms of the level of advice provided, and it may act as an important introduction to regulated services.
- Non-advised purchases and sales, where consumers choose a particular product without being advised specifically to do so.

Source: UK FSA—http://www.fsa.gov.uk/pubs/discussion/dp07_01.pdf

Annex V—Anti money laundering for agents and brokers under the US patriot act

What Responsibilities Will Agents and Brokers Have Under the New Rules?

The new insurance regulations do not require insurance agents and brokers to establish anti-money laundering programs or to report suspicious transactions themselves. However, FinCEN has made clear that life insurance agents and brokers will have an important role to play in insurance companies' anti-money laundering programs because they have direct contact with customers and are thus often in the best position to gather information and detect suspicious activity.

To assure that insurance companies and their distribution partners collaborate in preventing money laundering, the new rules require life insurance companies to integrate agents and brokers into their anti-money laundering programs and to monitor the agents' compliance with the programs. The preamble to the rules states that if efforts to integrate agents into insurance company programs are ineffective, FinCEN may reconsider its decision not to require agents and brokers to establish their own programs. The regulations are effective on May 2, 2006. On that date, insurance company programs must be up and running.

There are two new regulations requiring collaboration between insurance companies and their agents or brokers. In general, the first requires each insurance company to develop and implement a written anti-money laundering program, applicable to "covered products," that is reasonably designed to prevent the insurance company from being used to facilitate money laundering or the financing of terrorist activities.

These programs must (a) include risk-based policies, procedures and controls that, among other things, “integrat[e]” the company’s insurance agents and insurance brokers into its anti-money laundering program,” (b) designate a compliance officer responsible for the program, (c) provide for ongoing training of individuals, including agents and brokers, with responsibilities under the program, and (d) provide for independent testing of the program, including testing with respect to compliance of agents and brokers. The second rule requires insurance companies to report “suspicious activities” and to establish procedures to obtain information from agents and brokers, among others, necessary to detect and report those transactions. Each insurance company is required to establish an AML program that is “risk based,” which means that each company’s program must address the money laundering risks arising from the company’s particular product mix and unique business practices.

“Covered Products.” The rules are not applicable to all insurance products. Rather, the Treasury Department identified categories of “covered products” that in its judgment presented sufficient AML risk to justify regulation. **“Covered products” are defined to include:**

- A permanent life insurance policy, other than a group life insurance policy;
- An annuity contract, other than a group annuity contract; or
- Any other insurance product with features of cash value or investment.

Accordingly, property-casualty coverage, health insurance, and term life insurance, among other kinds of products, need not be included in an insurance company’s AML program. Insurance companies may offer guidance on which of their products are covered under their programs.

Customer Information. The new rules require insurance companies to collect customer information from agents and brokers, among other sources, to support their anti-money laundering programs and to detect and report suspicious transactions. FinCEN has made clear that insurance agents and brokers have a crucial role to play in this area:

Insurance agents and brokers are an integral part of the insurance industry due to their contact with customers. Insurance agents and brokers typically are involved in sales operations and are therefore in direct contact with customers. As a result, the agent or broker will often be in a critical position of knowledge as to the source of investment assets, the nature of the client, and the objectives for which the insurance products are being purchased.

Because each company's program must be risk-based, agents and brokers should expect to collect and retain information needed to assess the risk associated with particular business—in particular, to identify customers in high-risk businesses or high risk geographic locations, or those using products or services that may be more susceptible to abuse in money laundering activity.

Efforts will be made to assure that agents and brokers who sell insurance products through broker-dealers that have their own anti-money laundering programs will not be subject to inconsistent insurance company programs. These registered representatives will likely experience little, if any, change to their current customer due diligence requirements with respect to sales of variable products.

Contractual Arrangements with Agents and Brokers. FinCEN contemplates that companies will be expected to use their contractual relationships to require agents and brokers to provide them with information that may be useful for identifying potential suspicious activity. The contractual responsibilities of agents and brokers with respect to anti-money laundering programs will likely be similar the current responsibilities agents and brokers undertake in connection with company customer identification and anti-fraud procedures. Insurers already have numerous compliance and best practices guidelines that both captive and independent agents and brokers follow in order to continue doing business with them. Insurers also require very extensive information-gathering by many of their agents and brokers for underwriting purposes. It is expected that many insurance companies will adopt the same structural model for their anti-money laundering programs.

Source: ACLI