



March 18, 2008

CCIR Secretariat
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To the Canadian Council of Insurance Regulators (CCIR),

Re: An Approach to Risk-Based Market Conduct Regulation
A report prepared by the CCIR Risk-Based Market Conduct Regulation Committee

The Canadian Association of Financial Institutions (CAFII) is pleased to be able to provide input to the CCIR on the establishment of a framework for Risk-based market conduct regulation (RbMCR). In our submission, we have answered the questions set out in the consultation. In addition, we have proposed a model of regulation which applies the principles of risk based regulation to market conduct regulation. We would recommend that this regulatory model should apply wherever licensing is currently required. We believe this model is a workable approach for the wide range of insurance products and distribution systems available in the marketplace. We commend the CCIR on the progress it is making in risk-based regulation and we look forward to discussing our submission with CCIR representatives.

Yours truly,

Rick Lancaster
Chair



**Application of Risk-based Regulation Principles to the Market
Conduct Regulation of Insurance Distribution**

**Submission to
The Canadian Council of Insurance Regulators**

**by
The Canadian Association of Financial Institutions in
Insurance (CAFII)**

March 2008

The Canadian Association of Financial Institutions in Insurance (CAFII) is pleased to contribute to the CCIR's Risk-based Market Conduct model. We appreciate the opportunity to provide input to the CCIR on this important work.

About CAFII

CAFII membership is comprised of insurance companies licensed in all Canadian jurisdictions, which provide life, property and casualty, travel, creditor, reinsurance and other insurance products and services. CAFII members serve a major share of the Canadian insurance marketplace, collectively facilitating insurance protection to more than 10 million Canadians. CAFII members use an array of distribution methods such as call centres, agents and brokers, travel agents, direct mail, the Internet, and, for products authorized under the Bank Act for bank distribution, branches of deposit-taking institutions. CAFII therefore spans the insurance industry and is the only organization representing members in all the major lines of business. Our diversity enables us to take a broad view of the regulatory regimes governing the insurance marketplace.

Model of Regulation

In the CCIR's risk-based market conduct discussion paper, the CCIR has identified goals, principles and outcomes of risk-based regulation. The paper notes that, on a going forward basis, regulators will apply the principles of risk-based regulation (such as exercising judgment, actions to be commensurate with risk, reliance on corporate governance) to their everyday work. We support this approach. The paper does not, however, espouse a new model of how the market could be regulated using risk-based regulation. Below, CAFII sets out such a model, showing how the principles could be applied in a new approach to regulation. We would recommend that this regulatory model should apply wherever licensing is currently required. We call this approach the "Control Model".

As the CCIR noted in its new Strategic Plan 2008 -2011, "a technological revolution in computing and communications is spawning dramatic changes in the insurance industry. Declining costs coupled with rising computing power are enabling technological advances in the development and delivery of new insurance products....Canada no longer has the fundamentally homogeneous and slow to change financial services marketplace that the traditional rules-based approach to regulation was based upon."

The current regulatory model is focused on control and monitoring of individual agents. For direct distribution channels or those who offer only a limited product line, the current "one size fits all" individual licensing regime imposes excessive education, licensing and administrative costs, creating barriers to distribution relative to the public benefit derived. In particular, existing regulations compound the difficulty of serving the middle market

where the protection need is not being satisfied. A weakness of the existing system is that it is not scaleable. For example, the existing LLQP training and licensing regime is too extensive for simple insurance products, nor is it rigorous enough for more complex estate planning products that have insurance and savings components, beneficiary and tax implications.

The major changes proposed by the Control Model from the current regime are:

- (a) A shift in the regulatory focus from control and monitoring of individual agents to a regulatory regime that concentrates on management supervision of intermediaries and accountability, and
- (b) To establish the managers of intermediaries as accountable entities recognized by the regulator.
- (c) Scaleable regulatory requirements and control to match the risk profile of the products and distribution channel.

The cornerstone of the CAFII model is that market participants have accountability for what is under their control. It is useful to take a look at who the market participants are. In addition to more traditional forms of distribution, such as captive agents and independent brokers, the life insurance market now includes middlemen such as corporate agencies and Managing General Agents (MGAs), as well as direct distribution options like call centers, branches of deposit-taking institutions and the Internet. Direct distribution is now an established and valued channel for Canadian consumers. It is distinguished from traditional channels by the following features:

- Simple products
- Cost effective distribution and products
- Convenient and broad access
- Focus on meeting the needs of the underserved mass market

The CAFII recommended approach under the Control model would provide for licensing at the company level where oversight of market conduct takes place, and at the level of the manager of intermediaries. This means that the managerial level of the licensed party – an insurance company, brokerage, MGA or call center manager – is to provide the necessary oversight of intermediaries to ensure that market conduct standards are satisfied. The licensed party would be accountable for educating, monitoring, controlling and operating a distribution channel according to regulatory standards. Companies and managers who supervise intermediaries, are closely involved in hiring decisions and day-to-day management and are in the best position to ensure compliance. Intermediaries would be supervised by a licensed party who is the point of recourse for regulators. Instead of monitoring the activities of individuals, regulators monitor the practice of the licensed entities/managers of intermediaries based on the principles of market conduct.

Under this model, all interested parties would play important roles in market conduct regulation. Specifically:

Licensed Entity/ Managers of Intermediaries (e.g., call center manager, MGA, brokerage, insurer)

This first level provides the distribution controls that are the core of the model. This supervisory level:

- Takes responsibility for market conduct of intermediaries including screening for suitability, training, continuing education and compliance monitoring.
- Chooses methods of meeting market conduct standards, accounting for the nature, scope, complexity and risk profile of products and services offered and channels used.
- Registers distributors of more complex products with the primary regulator (see chart page 7).
- Meets a means test (capital, E&O, bond, etc.).
- Supervises distributors.
- Reports on market conduct issues regarding a distributor to the primary regulator.
- Ensures intermediaries have suitable credentials.
- Designates a person responsible for monitoring distributor compliance.

Licensed Insurance Providers (Product Producers, Owner/ Managers of Channels)

- Produces quality products, provides proper disclosure documents, arranges for channels of distribution, handles claims, and resolves consumer disputes.
- Accountable for the soundness of their products and practices, the accessibility and usefulness of disclosure materials, claims handling and complaint resolution.

Intermediaries /Channels (Agents, Brokers/MGAs, Employees, Call Centers, Internet)

- Finds clients, sources and explains products, provides client services, hires and trains representatives, and manages client paperwork.
- Individual intermediaries must register with a supervisor or qualify to be a supervisor who can register with the primary regulator.
- Follows requirements, codes of conduct and additional rules set by the supervisor.

Customers

- Responsible for seeking information on their intermediary and company, providing fair and honest information, and making complaints where necessary.

Government Regulatory Authorities

Instead of monitoring the activities of individual agents as is currently done, regulators would monitor the practice of managers based on principles of market conduct. This risk-based approach would enable regulators to focus their attention on those companies or individuals where risk is the greatest. It also makes clear that a manager is accountable for the activities of its representatives. The control model would see the regulator continue to set standards for market conduct in insurance distribution.

Specific activities for regulators would include:

- Establish market conduct standards.
- License entities.
- Monitor and collect information to ensure standards are being met.
- Set procedures to meet established market conduct objectives.
- Discipline those who fail to meet standards.
- Provide extra attention to entities with unacceptable control systems (risk-based approach to supervision).
- Maintain a central registry of distributors of more complex products, noting history of past problems, and advising new sponsors of any known issues with distributors they supervise.

SRO's (when delegated)

- Set standards for participants' competency and conduct, collect information and take enforcement action when needed.

This model promotes rigorous, accountable, risk-based regulation by refocusing regulatory attention from the licensing of individual insurance sellers towards increased scrutiny of the managers and accountability policies in place for the sale of products and the provision of advice.

The control model will provide uniformly high consumer protection and accountability across all distribution channels, while ensuring that all intermediaries are properly trained and supervised at a level that is appropriate for the products and services they offer. This will not only foster public protection, but also support innovation and improve accountability to the industry as a whole.

Goal of Market Conduct Regulation

The CCIR paper notes that the “overall vision for RbMCR includes regulators working with each other and the industry to identify, prevent, and solve marketplace problems or harms and to work toward positive marketplace outcomes”. CAFII concurs with this goal but would suggest that we should also acknowledge the importance of market efficiency. Accordingly, we would like to suggest that the goal statement should be extended to include “**with the least amount of regulatory intervention and burden**”.

Marketplace Outcomes

The paper asks if there are any other public policy goals/ marketplace outcomes of market conduct regulation. CAFII would recommend adding the following:

- acceptable consumer protection across channels,
- intermediaries appropriately trained and supervised for the products and services they offer, and

- access by consumers to a wide range of insurance protection products through multiple delivery channels.

Benefits of a Risk-based Approach to Market Conduct Regulation

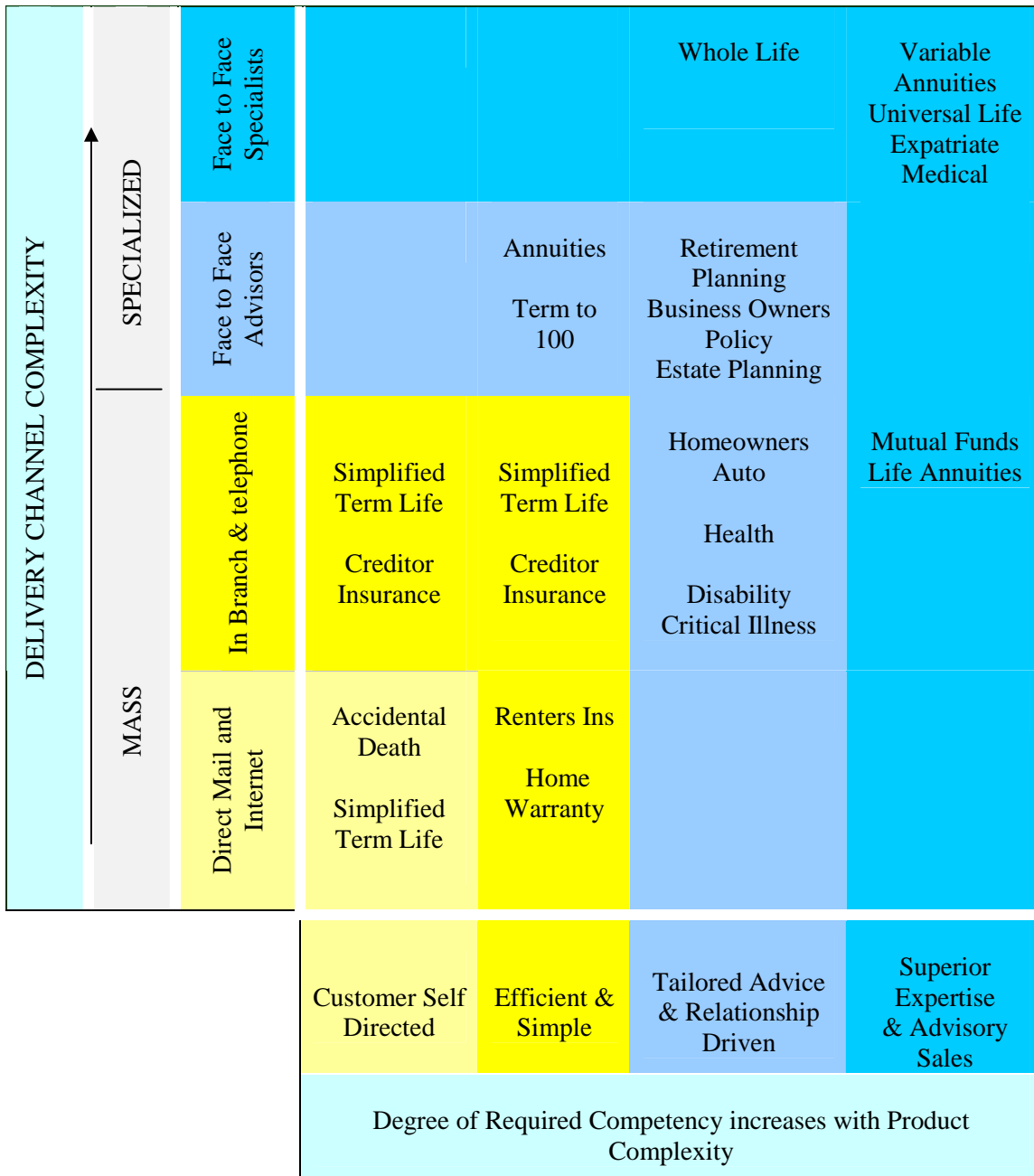
The paper notes a number of important benefits to be derived from risk-based regulation. We concur with those benefits and would like to add another based on the Control Model. **Risk-based regulation is scaleable - it supports adapting the regulatory system to varying levels of product complexity and channel controls.**

The following diagram illustrates the relationship between the needs of the market segments and the products and processes employed by the institution to meet those needs. It is clear from this illustration that it is appropriate to vary the delivery method for each quadrant of the diagram in order to best meet the needs of consumers. This requires a flexible approach to regulation, and in particular it requires a scaleable approach to determine the appropriate amount of training/qualification to deliver specific products (from simple through to complex) through a range of distribution channels employing different levels and types of internal controls.

A scaleable model allows regulators to protect the interests of consumers - whether they are involved in a self-initiated direct transaction for a simple product or considering the merits of a complex investment product on which an agent has approached and advised them. Consumer interest lies in the balance between providing adequate consumer protection and avoiding unintended consequences of regulation that deter or prevent consumers from purchasing the insurance that they need. For instance, the longer the time taken to comply with disclosure requirements during a telephone sales conversation, the lower the rate at which customers will remain engaged in the discussion and complete an insurance purchase.

We draw your attention in particular to the shaded area at the bottom left of the following chart. This is the section where mass distribution channels (such as direct mail, Internet, in-branch and telephone) with highly controlled processes which are customer self directed intersect with the distribution of products which are efficient and simple. Individual licensing in this quadrant would be considered excessive.

Insurance Distribution Model: Scaleable Control



Regulatory Principles for Risk-based Market Conduct Regulation

The paper sets out the following principles for risk-based market conduct regulation.

- Developing understanding of market and participants (includes complaint reporting)
- Reliance on governance and controls
- Exercising judgment (address most important things first)
- Selective use of tools
- Co-operation amongst regulators and with industry

CAFII concurs with these principles. The paper asks whether there are any other methods to improve regulatory understanding. CAFII would like to emphasize that reliance on a robust complaint reporting system such as the CCIR is implementing on a nationwide basis is a key source of information.

The paper states that reliance on governance is more easily applied to insurers than to intermediaries, and asks if there are equivalent alternatives. This statement is true if one considers the traditional model of regulation of the independent broker channel. It is not true of direct channels even today where the governance and controls of the company are directly applicable to employee intermediaries. The control model provides a way to increase the application of corporate governance and controls on all channels by putting the onus on licensed managers of intermediaries to be able to demonstrate that their controls meet regulatory standards. It also makes the licensee the avenue of recourse to the regulator. In the particular case of call centers, the licensee would be the corporate entity, thus the corporate controls are directly applicable to its staff.

Regarding risk assessment and management, the paper asks what other criteria regulators could use in determining which things are most important. Under the control model, it would become clear which entities are posing higher risk and require attention based on their ability to demonstrate compliance with regulator's standards. A licensee who has strong controls in place would not require regulator attention, whereas licensees whose controls are weak would warrant more attention. This would help to ensure reduced costs for well managed market participants as well as promoting regulatory efficiency by ensuring that regulators have a greater impact with limited resources by focusing on entities of higher risk.

The discussion paper has asked respondents specifically to comment on whether the principles of regulation apply equally to insurers and intermediaries. The question acknowledges the weakness of the current system of licensing individuals which has a built in "disconnect" between the intermediary and any associated corporate governance and control system. The individual licensing system is structured to put the onus on regulators to ensure that each individual intermediary is following standards. The control model puts the onus back onto the company and licensed manager of intermediaries to establish controls and ensure compliance of intermediaries with those controls. The control model will also aid regulators in their ability to exercise judgment and address the

most important things first; the regulator will be able to deal with licensees whose controls systems are not acceptable.

Harmonization

We note, as the paper points out, that the decision to adopt risk-based methodology is up to each province or territorial regulator individually. We would like to note that, should regulators adopt Risk-based market conduct regulation, it must be done in a harmonized fashion. Otherwise we will have different sets of principles, standards, guidelines and controls in every jurisdiction, which would make running a business on a national basis costly if not impossible.

CAFII appreciates the opportunity to provide input on risk-based regulation. We look forward to further discussion with the CCIR on the issue.