

# **Industry Practices Review Committee**

**Canadian Council of  
Insurance Regulators**

**Response to Consultation Paper**

**August 1<sup>st</sup>, 2005**



## Table of Contents

<b>1. Introduction.....</b>	<b>3</b>
<b>2. Client’s interest.....</b>	<b>8</b>
<b>3. Performance-linked benefits offered to intermediaries .....</b>	<b>9</b>
<b>4. Transparency of compensation, ownership and other financial interests .....</b>	<b>12</b>
<b>Independence or lack thereof .....</b>	<b>12</b>
<b>Compensation.....</b>	<b>14</b>
<b>5. Conclusion.....</b>	<b>16</b>

## 1. Introduction

The Policy Options proposed in the Consultation Paper fail to recognize some important issues at hand:

- § the large size of some industry players and its obvious potential to enable improprieties to occur;
- § the difference between commercial Insurance buyers and consumers at large;
- § the potential hardship that can be caused to the vast majority of Brokerage firms by the additional costs resulting from the application of even more regulation;
- § the impact of additional regulation on the price of products;
- § the fact that performance linked remuneration is completely ethical as opposed to volume, growth or retention linked remuneration;
- § the lack of independence of many industry players.

We believe Regulators **MUST** be very careful not to bring harm and chaos to an industry solely for purpose of managing appearances. The objective of Regulators should not be to maintain the appearance of propriety but propriety itself.

Regulators must also be careful not to treat all market players as guilty parties; let's remember that the present situation was brought about by the unethical activities of only a handful of people and organizations.



The facts brought to light by the Spitzer affair were not the doing of small or medium size organizations and their employees. These actions were only possible due to the large market shares controlled by the organizations guilty of impropriety. Let us keep in mind that 99% of intermediaries in Canada are small and medium size.

To use an analogy, when an individual commits a crime, society does not send its cousins to jail. As the majority of players in the industry are of modest size, it might be appropriate to recognize they are not in a position to replicate the actions uncovered in the Spitzer affair. Consequently, it might be more *à propos* to devise Policy Options to control large organizations rather than a whole industry of innocent by-standers.

The size and market shares of large Insurance Brokerage organizations allows them, as the case would be in any other industry, to pressure their suppliers, namely the Insurers. This pressure can come in many forms:

- § abuse of contingent commissions (as in the Spitzer case);
- § bulk transfer of portfolios;
- § agreements dealing with services provided by Broker to Insurer (contents imposed by Broker);
- § etc.

Therein lies one of the real risks of impropriety, which in our opinion, should be the target of any reform.

The lack of independence of many industry players is also very conducive to potentially improper or unethical behavior of industry players towards consumers in general. Financial dependence on another entity or the promise of financial support from another entity are very powerful incentives and should not be ignored. The consumers' interest, private and commercial alike, is more at risk of being violated when the Insurance industry players processing the transaction are financially linked.

We are also very mindful of the fact that ill-directed regulation will not solve anything except changing appearances. In addition, we fear it would needlessly burden small and medium-sized players in the industry with the additional costs required to achieve compliance. These additional costs, depending on their extent, might put some small Brokerage firms out of business, or be passed on to the "consumer" either by the Insurer or by the Broker, both of which are absolutely contrary to the objectives of fostering competitive markets and providing products at affordable prices.

The industry's ability to provide products at affordable prices is especially crucial to the Brokerage players at a point in time when private and commercial consumers alike are sending a very clear message to their Brokers about the fact that they are outraged by the profits of Insurers. It would

seem appropriate for Insurance Regulators to consider this previous issue as well; after all, it would be regrettable to cause an increase in Insurance prices for consumers and commercial organizations alike, due to the imposition of new but factually ineffective regulation.

We are troubled not only by the fact that the Consultation Paper does not address some very important issues, but also that it provides the same treatment for private consumers and commercial organizations. In our opinion, they are completely different in their knowledge of business dealings and the selection of products they purchase.

Private consumers are at the mercy of their Brokers and Insurers, since they are not as well informed of various business practices, and since they do purchase standard products of Insurers through an intermediary. An analogy would be that of a consumer entering a store and choosing a product off the shelf. As such, it is important to inform private consumers with more diligence on certain issues than one would commercial organizations.

When it comes to commercial organizations purchasing Insurance products, the “store shelf” analogy cannot be used. The complex and/or subtle nature of their needs require in depth analysis by their Broker and the tailoring of Insurance products. The role of the Broker is different in this case as it entails more work and requires more knowledge. As such, Commercial Brokerage should command higher remuneration than personal lines Brokerage. In addition,

the business community is well attuned to numerous business practices and, more often than not, negotiates their Broker's remuneration upfront. Therefore, it cannot be said that commercial organizations purchasing Insurance are at the mercy of their Broker and Insurers.

## 2. Client's interest

In view of the above, although we are not opposed to codifying the client's interest per se, we feel it is unnecessary and will simply be an added expense. The reason for our position is that all industry players are well aware of the fact that the client's interest **MUST** come first and that the vast majority of them conduct themselves accordingly. In addition, present industry regulation is already very clear in that matter, although not always expressed directly.

Every industry sector and every profession will, on occasion, discover unethical or illegal behavior by one of its members; greed is unfortunately a human failure. The Insurance industry is no more prone to this than other industries.

We feel that all industry associations should continue to promote ethics relentlessly to their constituents.

### 3. Performance-linked benefits offered to intermediaries

As mentioned above, the Policy Options proposed with respect to this topic are based on a false premise.

The risk of impropriety lies with large size intermediaries who control large market shares, and therefore, with all contingent remuneration which is linked to volume (including retention, growth and pure volume), as it clearly creates a conflict of interest.

It is important to note that the problems brought to light by the Spitzer affair had nothing to do with contingent commissions based on profitability. They were related to volume and to the power exerted by large Brokerage firms over equally large Insurers to be remunerated in a special way.

Any reasonably informed third party will understand that volume-linked benefits should be banned. They will, however, also understand that profitability-linked benefits are perfectly legitimate and acceptable and in no way constitute a conflict of interest. How can profit sharing on the total results of the portfolio placed with an Insurer on a yearly basis even remotely be perceived as a conflict of interest by a reasonably informed third party?

The only parties who would be punished by a total ban of contingent commissions are the small and medium-sized Brokerage firms who do not have enough market share to influence the market in any way. In addition, the large firms, who are at the root of the problem, have already chosen to renounce contingent commissions publicly in the wake of the Spitzer affair.

The Policy Option proposing for example to set a maximum dollar amount or a frequency regulation on contingent commissions is mind boggling. Are we really protecting consumers by selectively condoning a practice such as volume-linked benefits? (Allowing the practice but only in small doses???)

Furthermore, the power exerted by large firms can take many forms and create not only the appearance of a conflict of interest but rather an actual conflict of interest. One such form is the outright transfer of a portfolio from one Insurer to the other by a large Brokerage firm who wishes to receive additional remuneration from Insurers.

Consequently, we feel any Policy Option should target only volume-linked benefits (including growth and retention) and should also address portfolio transfers in circumstances other than the downgrading of an Insurer by rating agencies, the change of ownership of an Insurer, or a broad and sudden change in coverage imposed by an Insurer.

Legislation or regulation should be introduced to restrict Insurers from offering volume-linked (including growth and retention) benefits to their sales intermediaries. This restriction should be absolute. Profitability-linked benefits should be allowed to continue without any restriction.

Legislation or regulation should also be introduced to prevent large Brokerage firms from transferring portfolios of Insurance in block from one Insurer to another, unless under very specific circumstances (bankruptcy, downgrading of Insurer, etc.). In other words, portfolios transfers should only be allowed if they provide a benefit to Insureds first and foremost. That an advantage would also be derived by the Brokerage firm is fine, as long as the criteria regarding benefit to the Insured is met.

Any regulation should be principle-based.

#### 4. Transparency of compensation, ownership and other financial interests

Enhancing disclosure with respect to compensation, ownership or other financial interests is, in our opinion, an effective method to make private and commercial consumers aware of potential conflicts of interest and to give them the opportunity of requesting additional information to make decisions.

We definitely believe that any initiative in that area should be industry-led for the simple reason that industry players will understand the financial and administrative burden associated with the proposed initiatives. Initiatives should be applicable to all intermediaries, not only independent ones, as the lack of independence is certainly conducive to potential conflict of interest.

##### Independence or lack thereof

In our opinion, Brokers should be under obligation to reveal either their independence or their ties to Insurers or organizations of any type, be it with respect to ownership (owning or being owned in total or in part) or to loans made or received. The importance of their commercial dealings with such Insurers or organizations should also be disclosed. For example:

§ what percentage of a Brokerage firm is owned directly or indirectly by an Insurer;



- § what percentage of a Broker's business is placed with a single Insurer;
- § loans made directly or indirectly by an Insurer to a Brokerage firm and vice versa.

Evidently, the more important the commercial dealings with one party, in comparison to total business dealings, the stronger the possibility of conflict of interest.

The criteria for independence of an intermediary should be:

- § Total absence of ownership ties to any other organization;
- § Total absence of loans or other financial advantages from Insurers or other organizations;
- § No commercial relationship representing in excess of 10% of their total sales.

Disclosure of independence or lack thereof should be made:

- § by Insurers, by way of their respective websites and by way of a cover page attached to each Insurance Policy;
- § by Brokers, by way of their respective websites (as applicable) and by way of a cover page attached to each invoice.

We feel this type of disclosure would be an effective deterrent to impropriety towards private and commercial consumers alike. It would highlight potential conflict of

interest situations and induce or at least strongly encourage ethical behavior by industry players towards all consumers.

**Compensation** With respect to disclosure of compensation, we believe:

- § Insurers should disclose, by way of their website, the range of commissions they grant Brokers for the various lines of Insurance underwritten;
- § Insurers should disclose the terms of the contingent commission remuneration they award intermediaries, by way of their website and by cover page to each Insurance Policy;
- § Broker invoices to clients should bear a clear mention of the fact that they are remunerated by way of commission and/or fees and that any fees are shown separately on the invoice.

As is clearly shown above, we believe Insurers should bear the bulk of the responsibility for disclosure.

With respect to the actual amount received as remuneration by intermediaries, we believe it is almost always irrelevant to the client since clients tend to calculate the total disbursement for Insurance and Brokerage services with one Broker, and compare that amount with the total disbursement if they had used another Broker.

In addition, most commercial organizations are well aware of the remuneration possibilities for a Broker and when they are not, have no qualms asking directly about it; in our

experience, very few commercial clients question the level of remuneration received by their Broker when they are satisfied with the product and services purchased.

We therefore feel that as a general rule, it is not absolutely necessary for clients to know the exact remuneration received by their Broker.

## 5. Conclusion

As professionals, we are well aware of the fact that the client's interest must come first and we are not against additional transparency in the conduct of our business.

However, we feel the Policy Options proposed in the Consultation Paper do not address the issues that actually are problematic, such as the incredible economic power of large Insurance industry players and its equally incredible potential for conflict of interest or the lack of independence of many industry players. We believe Regulators should be concerned about regulation or practices that are intended to prevent actual conflicts of interests or impropriety, as referred to above, rather than to preserve mere appearances.

In addition, we feel that putting all players and consumers in the same basket does not do justice to the situation in our industry nor to all parties involved as it does not recognize the varied needs of different types of consumers nor their varied levels of sophistication.

If Regulators are intent on bringing about meaningful changes to the Insurance industry, when it comes to potential conflict of interest, we believe they need to reexamine their objectives and formulate new Policy Options with respect to contingent commissions and additional Policy Options with respect to disclosure of independence or lack thereof and with respect to the various forms of economic pressure that large intermediaries can use to

**obtain remuneration from Insurers, in addition to up front and profitability based contingent commissions.**

## Response to Consultation Paper

**B.F. Lorenzetti & Assoc. Inc.**  
**2001 McGill College Avenue, Suite 2200**  
**Montreal, Quebec H3A 1G1**

