Browne Jacobson

"It's the conduct risk, stupid!": FCA's study of competition in London wholesale insurance broking market

The UK Financial Conduct Authority (FCA) has published the final report (PDF) on its market study of the London wholesale insurance broking market.

18 March 2019

The UK Financial Conduct Authority (FCA) has published the final report on its market study of the London wholesale insurance broking market.

In the November 2017 terms of reference for the study, the FCA had proposed "an interim report in autumn 2018". The February report states, however, that "…a lack of material evidence of…need for regulatory intervention…[makes an interim report] inappropriate…". The competition market study is therefore over.

A number of headlines from commentaries on the study have focused on the above outcome. Less focus has been given to the FCA's identification of "areas which warrant further action", in relation to:

- conflicts of interest;
- the information that firms disclose to clients; and
- certain specific contractual agreements between brokers and insurers.

which the FCA says "can be addressed within our usual supervisory…and/or…enforcement processes…".

The above factors fall into the general category of "conduct risk", in particular the fair treatment of customers, especially by reference to the requirements in the Insurance Conduct of Business Sourcebook (ICOBS), paras 2.5R and 4.4.1 R, which requires a firm to:

- act honestly, fairly and professionally in accordance with the best interests of its customer; and
- provide the customer with information on the nature and basis of the firm's remuneration in relation to the contract of insurance to which the customer is or will be party.

As part of its study, the FCA commissioned FWD, a research consultancy, to interview insureds to explore "whether clients are sufficiently engaged and informed to make effective decisions" in purchasing insurance through the London wholesale insurance broking market. FWD's remit included:

- examining the extent to which clients are aware of the charges their brokers make;
- providing insight into clients' views about value added by brokers.

FWD's report, dated January 21, 2019, states that it conducted 53 telephone interviews with senior executives from UK and international intermediaries or insureds, including 12 corporate insureds. In relation to potential conduct risk issues FWD identified that: "Three respondents mentioned the use of restrictive practices between brokers and underwriters. In particular, they referred to 'blocking' arrangements in which underwriters working with a broker on a specific risk refuse to quote on that risk for another broker.

"Four respondents said that broker charges are not fully transparent in some instances. Their concerns relate to reinsurance placements and levels of commission for certain classes of insurance. In some instances, it was claimed there is [a]…lack of consistency when implementing increased regulations."

In considering the conduct risk ramifications of the FCA report, it is worth remembering the report's summary of the "London broker's" role and remuneration:

- "The role…is to place their clients' risks with insurers with the capacity, risk appetite and financial strength to underwrite them.
- This…service is complex, requiring expert knowledge of the risks faced by each client (typically large corporates with complex risk-placement needs).
- It also requires good knowledge of how these risks can be underwritten and by whom, to ensure risks are placed appropriately.
- When placing risks for clients, brokers receive remuneration from the client (as a fee) and/or from the insurers who underwrite each risk (as commission)."

The FCA report states that "brokers receive higher remuneration rates from placing risks into their own facilities [pre-selected or pre-agreed arrangements with insurers] and [their own] MGAs [managing general agents — intermediaries with underwriting agency for insurers] than in the open market…".

The report identifies that broker remuneration is higher by:

- 2.5-7.5 percent on facilities (10 percent higher on certain specialist risks, such as aviation); and
- 2 percent (based on 2016 data) where brokers involve MGAs that they own.

The report concludes that "the higher remuneration may incentivise the broker to use a facility or MGA when this is not the case", but that any such conflict of interest "could be mitigated through effective conflicts of interest policies".

The FCA's review of brokers' conflicts of interest management systems raised concerns as to whether firms can effectively manage their conflicts, however:

- "In just over half the [conflicts policies], the conflicts were articulated at a high level with little description or explanation of the nature of the risk [or its mitigation]".
- "In at least a third of [conflicts logs], rather than…general business model risks, they had a focus on personal conflicts…".
- "Firms often lacked clear processes for governance overseeing the placing business via facilities."

The FWD report contains further evidence as to the risk of conflicts of interest mismanagement. One of the corporate policyholder interviewees had: "…concerns…that the broker is not really going around pushing our business to get the best deal. The concern was heightened when an overseas element of our business got a 'better quote' from the [London wholesale insurance market] than our incumbent broker, and had to ask [the] London insurer to reduce premiums as a result."

Another such interviewee stated: "When you have a broker placing the same policy year after year, feeding the insurer, it is very difficult to break the relationship even if it is not in the best interest of the client. It is the human relationship factor. Brokers are not truly independent."

A previous article published on Thomson Reuters Regulatory Intelligence referred to the final notice in respect of Bluefin Insurance Services Ltd, dated December 2017. Anticipating the above concerns, that notice referred to a situation where a Bluefin employee "requested a quote [for a customer] from…[one insurer which] had been identified by Bluefin as the 'target insurer'. The customer [independently]…obtained a quote from an alternative insurer for almost half of [that from Bluefin, which] subsequently obtained a matched quote…".

The FCA also criticised Bluefin in relation to its conflicts of interest controls. In particular, the FCA found that Bluefin's:

- conflicts of interest policy "had not been implemented properly because brokers were not carrying out their broking activities in line with the revised policy"; and
- conflicts of interest register referred to a 2011 report that "set out steps that Bluefin had taken to manage" a potential business model conflict, but those steps "did not sufficiently mitigate the risks associated with" that conflict.

The findings from the market study and the Bluefin final notice provide evidence in support of the proposition that there is a discernible degree of failure within the insurance market as a whole with respect to the adequate management of conflicts of interest between brokers, their customers and insurers.

This proposition is reinforced by the FCA's findings about "restrictive clauses" in a small (but apparently noteworthy) number of agreements — "mostly for facility placement" — between brokers and insurers:

- "most-favoured-nation" clauses "which stipulate that insurers must work with brokers to ensure that:

- the terms of [a] facility remain market-leading, or…
- the insurer may not offer better terms on the open market",
  which could therefore "prevent the insurer from offering its best terms or policy" to customers; and
- "client exclusivity clauses" which "restrict insurers from providing quotes to other brokers for clients of the broker with which a facility is set up, or to these clients directly" and could therefore "make it less easy for clients to shop around".

While the London wholesale insurance market's structures might not infringe competition law, market participants are not out of the woods on conduct.

This article was originally published by Thomson Reuters Accelus Regulatory Intelligence on 12 March 2019.

Contact

Jeremy Irving

Partner

jeremy.irving@brownejacobson.com

+44 (0)20 7337 1010

Related expertise

Services

Financial institutions

Products liability