

Good insurance business # 1 - Insurance Product Value and the duty to act in the best interests of customers: risks from intermediary remuneration

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FG19/5 has a number of inter-linked messages for manufacturers (which would normally be expected to be or include insurers) and distributors (which would normally be expected to be intermediaries).

The upshot of the guidance as a whole is that the FCA is concerned that the remuneration arrangements between manufacturers and distributors are being added, or otherwise factored, into the ‘gross’ or ‘retail’ premiums paid by customers in such a way, and to such an extent, that products cease to represent fair, let alone good, “*value*” for customers.

In particular, the FCA is concerned that GI market remuneration arrangements may breach the “*customers’ best interests rule*” set out at paragraph 2.5.-1 of the “*Insurance Conduct of Business Sourcebook*” (“ICOBS”): “*A firm must act honestly, fairly and professionally in accordance with the best interests of its customer*”.

ICOBS 2.5.-1 is given specific force as to remuneration via the rule at 19F.2.2 of the “*Senior Management Arrangements, Systems and Controls Sourcebook*”:

“(1) [*Insurance intermediaries and insurers*] must not:

(a) *be remunerated; or*

(b) *remunerate or assess the performance of their employees,*

in a way that conflicts with their duty to comply with the customer’s best interests rules...”

(referred to below as “**Remuneration Conflict of Interest**”).

Value

The FCA takes a broad view of “*value*”:

“*the interaction between the overall costs to the end customer and the quality of the product and services...whether the product is compatible with the objectives, interests and characteristics of the [“intended customers”], as well as the cost and charges of the product itself...*”

“*Quality of the product*” includes “*the level of cover under the policy, how claims are handled or other services provided by the manufacturer or other parties in the chain*”.

However, the FCA excludes from the ‘quality’ concept “*services that distributors...provide...separately to...the product and under separate (for example, fee) charging arrangements*.” In other words, the FCA will not give credit for businesses that provide a mix of insurance and

non-insurance (or non-financial) services and which argue that the overall balance of this mix represents good value for customers: the FCA is only interested in the insurance product's value.

In relation to the effect of intermediary remuneration on product value, the FCA is interested in:

"...the difference between the risk price and the end premium paid by the customer including any commission received by other parties in the distribution chain".

In particular, the FCA requires manufacturers to:

- *"...consider the impact of [distributors' remuneration] on the value of the product"* where *"the final selling price of the insurance"* reveals such remuneration, and
- ask distributors for *"...relevant cost/remuneration information...[and] to demonstrate how their remuneration is consistent with... obligations"* (e.g. customers' best interests).

Remuneration

The relevant definition of remuneration in the FCA Handbook is:

- *"...any commission [i.e. "remuneration included in the insurance premium"],*
- *fee [i.e. "remuneration payable directly by the customer" separately from commission],*
- *charge or other payment, including an economic benefit of any kind or any other financial or non-financial advantage or incentive offered or given*
- *in respect of insurance distribution activities [in short: dealing in insurance as agent; advising on, arranging, or making arrangements with a view to transactions in, insurance; and assisting in the administration and performance of an insurance contract]"*

The FCA also gives guidance at ICOBS 4.3.-3 as to remuneration provided between manufacturers and/or distributors, including:

- *"...indirectly by the insurer or another firm within the distribution chain; or*
- *...by way of a bonus (whether financial or non-financial) paid to the firm by the insurer or another firm...where this bonus is contingent on the achievement of a target to which the distribution of the particular contract of insurance could contribute.*
- *For example, this can include...profit share arrangements, overrides or other enhanced commissions."*

There are rules in ICOBS as to the disclosure to customers of the "nature" of remuneration (eg at ICOBS 4.3.-7), and guidance (ICOBS 4.3.-4) as to disclosure of the "source" of remuneration. ICOBS 4.3.-5R bolsters the guidance at 4.3.-3:

"The remuneration referred to in this section includes remuneration that is not guaranteed or which is contingent on meeting certain targets."

Of course, the above rules on disclosure may apply to insurers and *"any insurance intermediary in contact with the customer"* (see ICOBS 1 Annex 1 Part 2, rule 4), but some intermediaries may have no contact with the customer. But the issues on remuneration go further than its disclosure or disclosability by certain parties. FG19/5 emphasizes that *"...disclosure cannot be relied on as a satisfactory means of discharging [Remuneration Conflict of Interest]"* and so firms need to consider if they need to change distribution – and especially remuneration – arrangements in which they are involved, regardless of any disclosure right or obligation.

Factors that FG19/5 expects firms to take into account include:

- *"...remuneration which bears no reasonable relationship to [a distributor's] costs or workload to distribute the product...and...could incentivise the [distributor] to sell a product which does not provide value to the customer..."*
- *A distributor[s]...involvement in the distribution chain provides little or no benefit beyond that which the customer would receive from the product anyway...[which] could indicate that the customer is being [over-]charged..."*
- *...distributor[s] receiving remuneration which incentivises them to propose or recommend a product which either does not meet the customer's needs, or does not meet them as well as another product would do."*

The FCA expects *"...distributors to monitor the products they offer, and their distribution arrangements, on an ongoing basis. This enables them to act if they identify situations where the product is not providing the intended value to customers..."* The FCA regards such a shortfall in value as a cause of *"customer harm"*, which includes *"situations where...the level of [distributor] remuneration...is unlikely to be consistent with the customer's best interest rule, because of its impact on the value of a product."*

The FCA's view is that *“When distributors identify that the product is resulting in customer harm, they should inform the manufacturer and, if necessary, amend the way they distribute the product. This might include...reducing the amount of remuneration they receive or ceasing to distribute the product entirely.”*

Disclosure has been favoured by the insurance industry because it implicitly (or at least arguably) results in the insured's consent to forms and levels of remuneration on which the industry has come to rely.

Of course, consent is undermined unless it is made on a properly informed basis. FG19/5 does not address this, or seek to elaborate on firms' disclosure obligations as to remuneration. It may be that the FCA feels that remuneration disclosure is an unsuccessful means of preventing customer harm from products whose value is disproportionately low for the customer because they are disproportionately high for insurers and/or intermediaries.

It seems that the FCA instead takes the view that firms in distribution chains must police themselves and each other – and the FCA will enforce against ineffective self-policing.

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