Submission on: Relationships between Insurers and Sales Intermediaries Consultation Paper

NATIONAL INSURANCE LAW SECTION
CANADIAN BAR ASSOCIATION

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PREFACE

The Canadian Bar Association is a national association representing 34,000 jurists, including lawyers, notaries, law teachers and students across Canada. The Association's primary objectives include improvement in the law and in the administration of justice.

This submission was prepared by the National Insurance Law Section of the Canadian Bar Association, with assistance from the Legislation and Law Reform Directorate at the National Office. The submission has been reviewed by the Legislation and Law Reform Committee and approved as a public statement of the National Insurance Law Section of the Canadian Bar Association.

Submission on:
Relationships between Insurers and Sales Intermediaries Consultation Paper

I. INTRODUCTION

The National Insurance Law Section of the Canadian Bar Association (CBA Section) appreciates the opportunity to participate in this stakeholder consultation on possible new regulatory responses, as contained in the Consultation Paper, *Relationships between Insurers and Sales Intermediaries* (Consultation Paper).

II. BACKGROUND

The current review by the Industry Practices Review Committee of the Canadian Council of Insurance Regulators and the Canadian Insurance Services Regulatory Organizations (CCIR/CISRO) relates to the Spitzer investigation commenced in October 2004 against an insurance broker, Marsh & McLennan. Part one of the civil complaint is that employees at the brokerage were engaged in "bid rigging" and price fixing and had conspired to manipulate the insurance market. Part two of the civil complaint is that Marsh & McLennan did not disclose to clients that it received contingent commissions from insurers based upon premium volume and persistency (renewal rate of policies). Other insurance regulators and state governments in the United States expanded the investigation.

In response to these developments in the United States, the CCIR and CISRO established the Industry Practices Review Committee (IPRC) to examine the financial relationships between insurance companies and their sales

intermediaries that have the potential for creating conflicts of interest. In late 2004, CCIR and CISRO sent out a survey to the participants in the industry seeking answers to specified questions. The results of the survey have been disclosed. No illegal activity such as "bid rigging" was disclosed. The market in Ontario was shown to be very competitive.

The Property and Casualty (P&C), Life and Health (L&H) and Brokerage industries, in response to the civil complaint and the survey, have all taken steps to address some of the concerns itemized in the survey. These industry responses are voluntary but appear to have been widely adopted by the participants in the industry.

It is also important to note that this investigation and the response by the industry participants have not been driven by consumer complaints.

The steps taken to date by the regulators and the industry are designed to address a number of objectives:

- Market confidence
- Informed consumers
- Level playing field
- Responsive insurance regulation
- Harmonization
- Competitive markets

CCIR/CISRO have asked for input from the CBA Section on the matters set out in the June 2005 Consultation Paper.

III. CBA SECTION POSITION ON POLICY OPTIONS

The new regulatory responses considered in the Consultation Paper are:

1. Codify the priority of the client's interest;

2. Restrict performance-linked benefits offered to intermediaries; and
3. Enhance transparency of compensation, ownership and other financial interests.

1. Codify the Priority of the Client's Interest

Industry rules/guidelines currently in place govern insurance sales transactions. As well, provincial and territorial regulatory bodies commonly require in their rules/bylaws that insurance advisers act in their clients' best interests. All of these rules and regulations establish the priority of the client's interest. In addition, the courts in the provinces and territories of Canada recognize that insurance advisors have to put clients' interests ahead of their own in the performance of their duties.

Advisors who put their own interests ahead of the client will face consequences from the industry, the regulator or the courts. There is a comprehensive legal framework for consumer protection in Canada.

The CBA Section's position is that that the priority of the client's interest is already recognized in law and that there is no need for further legislation to codify it. However, the provinces and territories do not have consistent approaches on how an advisor is supposed to respond to a conflict of interest. The Industry Practices Review Committee should consider recommending that these approaches be harmonized.

2. Restrict Performance-linked Benefits Offered to Intermediaries

- Travel Incentives

Previously, advisors were not required to disclose travel incentives or other non-monetary benefits to clients. These benefits are not prevalent in the P&C industry but, through custom, are common in the L&H industry. Insurers use these benefits as a means of motivating the distribution channel to work harder and to sell more product. Under the new L&H guidelines being implemented by the Canadian Life and Health Insurance Association (CLHIA) these incentives must be disclosed. This disclosure is required even though an advisor, who has to qualify for the benefit, is not able to predict accurately at the beginning of any qualifying period that he or she will in fact qualify.

There does not appear to be anything wrong in principle with rewarding sales people with travel bonuses. This is common in any sales-related industry. The issue from a consumer’s perspective is this: Did the advisor sell me product from this company because it is suitable to my needs, or did the advisor sell me an unsuitable (or less than suitable) policy to qualify for this bonus?

If the advisor made a decision to sell this policy in order to qualify for a bonus, then the advisor has clearly made a decision that may not be in the best interest of the client. According to the regulatory and professional framework in place today, the advisor could be sanctioned for conducting such a sale.

The questions to be considered before deciding whether a legislative response is required are: Is further investigation required in order to determine the extent of any problem in the industry? If not, is this particular problem with travel incentives so widespread as to merit banning the practice in its entirety? If the practice is banned, what level of appreciation can a supplier show to its producers, before the “appreciation” can be viewed as an improper incentive? How would the ban be enforced?

- Offering Services and Assistance

One of the questions addressed in the Consultation Paper was whether an insurer offering services (such as office space) to an intermediary created a potential conflict of interest and whether a regulatory response was required to address it. This is a difficult question to address as the answer depends upon the level and value of services provided by the insurer and whether advisors have to qualify for this level of service based upon sales targets. Presumably, the greater the value of the service and its limited availability, the greater the potential of a conflict of interest.

Banning these support services in all circumstances does not appear to serve a useful purpose as, presumably, consumers are benefiting to some extent from these services being made available to independent advisors.

The CBA Section believes that it would be almost impossible to draft a regulation to address this issue and be capable of distinguishing between valuable services and merely offering simple business conveniences. It would be extremely difficult for a regulator to cost-effectively enforce any prohibition of these support services.

3. Enhance Transparency of Compensation, Ownership and Financial Interests

- Compensation Disclosure

The survey results indicate that the issue of compensation disclosure for the P&C industry is quite different from the considerations in the L&H industry. If regulations are passed, different ones may be needed for the P&C industry and the L&H industry. The biggest distinction between these two industries is that the P&C contract is a short-term arrangement — six or twelve months. The contractual relationship on the L&H is for a much longer term — several years at a minimum.

The P&C industry has adopted a voluntary guideline whereby the independent broker, at the time of sale, gives the client a list of all the companies they represent and the commission scales paid by those companies for different products.

The sample disclosures reviewed are simple to understand and effective. Disclosing the actual dollar amount of the commission would not add any information of significant value to a consumer and would increase the regulatory burden on the advisor.

The consumer's concern when they purchase a product from an independent advisor is that the advisor is recommending an insurance company that can meet their needs and provide the required level of coverage and service for the best price. The consumer does not necessarily want the cheapest insurance — coverage may be inadequate or the company may provide poor service in the event of a claim.

- Effect on Life and Health Companies

An L & H insurance contract is, by its nature, a long-term contract. Disclosure of any commission should take into account that longevity. For example, the life industry often pays heaped commissions in the early years of the contract, and lower commissions in the later years. By merely informing the client of the first year commission and bonus, the client will receive a distorted view of the commission structure. For example, the first year commission and bonus on a universal life product payable to the advisor is often well in excess of the initial premium. Most consumers would be confused as to why the commissions are so high. If commission is to be disclosed, it should be an average commission based upon the number of years most policies of this type are likely to stay in force.

If advisors are required to disclose the compensation without using an averaging formula, the industry may move to a new commission structure that is more

understandable to consumers, for example, levelized commission or salaried commissions. The amount of total compensation paid to the advisor may be the same (or higher or lower, depending upon how long the contract is in force) but it may be easier to explain. Changing the compensation disclosure rules will not likely reduce the cost of insurance for consumers.

However, levelized or salaried commissions may be less attractive to advisors, resulting in unintended and undesirable consequences to consumers and industry participants. For example, brokers may move away from selling life insurance and sell other types of financial products. Consumers would then have fewer choices of products to buy, and where to buy them. The cost of insurance may increase due to decreased competition.

If the regulator concludes that high first-year commissions are of concern for the consumer after conducting a thorough analysis of the issue, then it should regulate this directly rather than through disclosure requirements.

- Rebating

If a broker must disclose either the commission or the rate of commission, will the consumer expect that the broker can reduce the commission and rebate the difference to the consumer? The consumer may view commissions as negotiable items. Rebating insurance commissions is currently illegal in many jurisdictions. There may be pressure on advisors to engage in this illegal practice in order to satisfy consumer expectations and demands. A change to these disclosure rules may bring a corresponding need to relax the rules on rebating commissions. If so, IPRC should recommend that any changes to the legality of rebating should be consistent across Canada.

- Contingent Commissions

According to the survey, contingent commissions are common in the P&C industry but not common in the L&H industry. The P&C insurers will pay a

bonus of 2-3% based on criteria established by that insurer. These bonuses will be determined over a period of three years and are, in effect, a reward to the distributor for selling profitable insurance. It appears that a broker would not be able to steer clients toward any one insurer in the expectation of receiving this bonus. There are too many variables to anticipate and the period of time is so long that it should effectively prevent an advisor from manipulating the sales process for each client. Further, different companies have different weightings for the variables. According to the voluntary disclosure practices adopted by the P&C industry, the possibility of earning a contingent commission is being disclosed to consumers. It does not appear that an advisor is capable of providing more detailed information.

- Financing and Loans by Insurers of Sales Intermediaries

The brokerage industry often needs access to capital to finance its operations. This is particularly true as the industry consolidates and family-run operations are consolidated. Banks have not necessarily been receptive to financing advisor operations and that is the reason why financing from the insurer is popular. In the past, incentives were often attached to the financing. This may have encouraged an independent advisor to steer clients to that insurer in order to obtain a more favourable interest rate or some other advantage for the repayment of the loan. However, in the current environment, the trend of insurance companies is towards full disclosure to consumers of financial relationships between brokers and insurers. Having to disclose such arrangements is likely a deterrent to insurers offering new loans with terms that become more favourable depending upon the volume of business directed to the insurer.

Banning loans by insurers to brokers would remove a longstanding source of capital for the broker industry. Unintended consequences may include a decline in competition. Smaller brokerages, with less capital, will not be able to compete and will be compelled to merge into larger operations.

If the loan is disclosed to a consumer (as the new voluntary guidelines require) the consumer will be aware that there is a business relationship with the insurer. The advisor, in order to maintain the confidence of the client, must be able to demonstrate to the client that the product selected is the best product for that client. If the advisor, after disclosing the business relationship with this insurer, is unable to convince the client that this insurance company offers the most suitable product, then the client will lose their trust in that advisor and will probably find a new advisor. It appears that the requirement to disclose the business/ownership or financing relationship should create a self-regulating situation where the independent advisor, in order to retain clients, must demonstrate that the recommended product is appropriate for the client.

As for the level of disclosure, it should not be necessary to disclose to a client the terms of any financing or loan arrangement or the details of any share ownership. That information is private and potentially sensitive. It is not necessary for the consumer to know the terms of the loan in detail (or the share ownership split) in order to be educated about a possible conflict of interest.

- Definition of Advisor

There are potentially many different categories of advisor — from captive (contracted to only one insurer) to independent and variations of these two categories. It is important to recognize that any regulatory response does not create a situation where one category is placed in a situation where it has an advantage over the other category.

- Distribution Channels

The marketplace is changing dramatically. Consumers can purchase insurance from a variety of sources other than the traditional broker channel through:

  - the web;
  - call centres;

- employer plans;
- direct mail; and
- affinity marketing programs.

The marketplace is therefore a very competitive environment, with many different participants. It is important to recognize that any regulatory action does not create a situation where one category of distribution is placed in a situation where it has a competitive advantage over the other categories simply because it does not have to comply with a regulatory burden that a competing distribution channel has to address.

- Transparency and Meaningful Disclosure

When it comes to consumer disclosure, “more” does not necessarily mean “better”. Disclosure must be provided at a level that is meaningful to the consumer. It should be the desire of the industry participants and regulators to provide as much information to the consumer as early in the transaction as possible. However, if the information is too complex, few consumers will review it. An additional consideration is cost versus benefit. There is also a cost to the industry (and eventually the consumer) in providing disclosure that must be justified in terms of its usefulness to the consumer.

Obviously, if the requirements for disclosure are too complex and burdensome, there will be consequences.

1. Consumers will not understand and the majority of consumers will probably ignore any documentation provided to them;

2. If advisors find it difficult to comply with a regulatory burden, they will seek ways to simplify the burden. For example, an advisor who currently sells product from twenty different insurers may decide to only contract with eight different insurers. This could lead to the market concentration (an unintended and negative consequence) as advisors stop selling the product of some insurers;

3. The number of small insurance brokerages could decline as the cost of compliance becomes greater. Only larger brokerages, that can spread the cost of compliance over a larger customer base, will be able to compete; and

4. Complex and costly disclosure will probably lead to a more concentrated market with fewer participants (again, a negative and unintended consequence).

IV. CONCLUSION

Before enacting legislation to address potential conflicts of interest arising out of the insurer-intermediary relationship, the CBA section submits that regulators must consider the advantages of regulation over an industry response. The advantages and disadvantages of the regulatory response and of the industry response are as follows:

Regulatory Response - Advantages

- There will be uniform rules on these issues across Canada,
- There will be a level platform for all industry participants, and
- There will be a high degree of compliance.

Regulatory Response - Disadvantages

- A regulatory solution may be expensive and difficult to enforce,
- If all provinces do not adopt same solution it may lead to public confusion and expensive regulatory compliance, and
- A regulatory response can be inflexible and difficult to modify as conditions change.

Industry Response - Advantages

- The vast majority of industry participants have agreed to participate,
- It is much more flexible and easier to modify as conditions change, and
- It is cheaper to administer for both the regulator and the industry.

<u>Industry Response - Disadvantages</u>

- Some companies may not fully comply, and
- Sanctions may not be available to compel compliance.

The CBA Section submits that it would be premature to choose the regulatory response at this time. The voluntary initiatives of the P&C industry, the L&H industry and broker associations have not been fully implemented and considered. These voluntary initiatives appear to be well suited to address the issues at hand. CCIR and CISRO should wait and review these voluntary initiatives before recommending regulatory changes.

The CBA Section appreciates the opportunity to provide input to the IPRC about the issues presented in the Consultation Paper. We trust that our comments will be helpful.