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Is insurance the new banking? Part 1: GI market and SM&CR

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It has been suggested that the market is merely the collateral victim of regulators' actions in respect of the banking industry ('it's the bankers' fault!').

This article is the first in a series that considers whether such a suggestion is correct. Are UK regulators newly seeking to apply to the insurance industry standards and frameworks originally or primarily, perhaps more properly, applicable to the banking industry? In other words, 'Is insurance the new banking?'

Complainants about the treatment of the general insurance market might, for instance, point to the Senior Managers & Certification Regime (SM&CR). The Financial Conduct Authority (FCA) has explained the genesis of the SM&CR as follows:

"In response to the 2008 banking crisis and [later] … conduct failings … Parliament set up the Parliamentary Commission for Banking Standards (PCBS) to … improve standards in … banking...

"PCBS recommended a new accountability framework focused on senior management … that firms take more responsibility for employees being fit and proper, and that there be better standards of conduct...

"legislation in December 2013, [led] to the FCA and Prudential Regulation Authority (PRA) applying the SM&CR to the banking sector … further … legislation in May 2016 [extended] the [SM&CR] to all … authorised firms."

The above supports an argument that recent regulation is a by-product of banking regulation. There is, however, an alternative view, derived from the period between the introduction of the Financial Services and Markets Act 2000 and the 2008 financial crisis: current regulatory initiatives are connected to issues identified in that period.

In 2002 the FSA published a "Future of Insurance Regulation - progress update" that included the following issues for general insurance:

- outsourcing – controls over agreements and management;
- risk management – processes to identify, assess, mitigate and report risks;
- documentation – of procedures and controls, of computer systems, and reporting the operation of key controls;
- responsibilities – documentation and control of limits and authorities delegated to subsidiary companies, sub-committees, management and staff.

In October 2004, the Attorney General of New York issued proceedings against various intermediaries alleging that certain commission arrangements with certain insurers led to the placement of risks with those insurers, without insureds' knowledge of those arrangements or their ramifications for choice over counterparties, terms and premiums.

The proceedings led to extensive commentary as to general insurance working practices and were mentioned in the FCA's 2017 terms of reference for its study of the wholesale (GI) brokers market.

In December 2004, a speech by John Tiner of the FSA famously challenged the UK – and, in particular, the London – market to end its "deal now, detail later" practices and culture, which left insureds, insurers and intermediaries facing operational and legal risks through the absence of timely and complete documentation of contractual terms. The market focused heavily on this documentation issue, which resulted in the introduction of highly publicised 'contract certainty' processes.

The speech identified various other cultural problems. It cited a November 2004 report by the Centre for the Study of Financial Innovation that the insurance market was "riddled with the kind of Spanish practices that banking dumped years ago". The speech highlighted inter alia "conflicts of interest" and "quality of systems and controls around binding authorities" plus the need for "high standards in … claims handling".

Given the above history of regulator pronouncements, it is arguable that regulators are catching up on applying greater controls over the conduct of firms and their key individuals. This may be because regulators were distracted from doing so by the financial crisis and the reappraisal of banking regulation. As such, it is arguable that 'the bankers' provided the insurance market with a decade's delay in an otherwise inevitable process of regulatory re-engineering.

A viewpoint as above is likely to have been strengthened by recent findings as to previously-identified problems. Last month, the FCA issued Thematic Review (TR19/2) on the general insurance distribution chain. Its aim was to scrutinise general insurance distribution arrangements that "have become long and complex, with multiple parties involved in the manufacture, distribution and delivery of insurance products and services" especially where there is "significant influence from parties that are not FCA regulated".

The review was of three products; travel, tradesman and Guaranteed Asset Protection (GAP)/motor ancillary insurance:

- "Tradesman [liability] … is … bought by small businesses … [and so gave] … insight into the commercial value chain;
- Travel … is … arguably essential for overseas travel but not compulsory … [it is] sold through a very wide range of distribution routes … [thus giving insight into the way] … different distribution chains contrasted and affected the value of the product;
- GAP … [is] widely sold … [thus giving] an insight into the dynamics and economics of a … distribution chain where ownership of the customer relationship often resides with the seller of the primary product."

The review identified "Specific examples of … potential harms" including:

- Prices which appear significantly higher than the production and delivery costs of the products due to high levels of commission within the distribution chain … [including] GAP … purchased alongside a motor vehicle, where the average level of commission taken by some distributors was more than 60 percent. These distributors were often directly regulated intermediaries or appointed representatives ('ARs') forming part of an otherwise unregulated group, like a motor manufacturer or dealership network, and they appeared to be able to extract these levels of commission due to the control they could exert over both the distribution chains and the customers.
- Firms failing to fulfil obligations … including … where the responsibility for handling claims had been delegated, creating the risk that legitimate claims could be rejected."

The review identified two key causes for the above:

- "the purpose and values of firms, and associated issues with their business model and strategy … [and];
- poor governance and oversight and the failure to have adequate systems and controls over the end to end product and service development, manufacture and delivery chain."

Manifestations of the above causes included:

- inadequate consideration and control of "risks of harm to customers …";
- Insurers and authorised wholesale (or 'upstream') intermediaries "ceding complete control over … the product sale (including allowing absolute discretion over the end price charged to customers) to [more 'downstream'] distributors …";
- inadequate due diligence and risk management of "the suitability and ability of parties to whom [distribution] is … delegated …"

From a regulator's perspective, there is clear continuity in the issues summarised in 2002-2004 and 2018-2019. The regulator has the same concerns, and the practices giving rise to those concerns are in essence the same:

- customer ignorance of the distribution cost component in premiums;

- customer mistreatment through distribution/outsourcing;
- customers' loss from unpaid claims, and
- firms' inability to prevent the above risks.

Perhaps for regulators general insurance is not so much 'the new banking' but an 'old chestnut' or tough nut that the SM&CR can help crack.

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