Commercial insurance commission disclosure: Market Failure Analysis and high level Cost Benefit Analysis

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Acknowledgements
During the course of this project we spoke to, and gathered data from, a wide variety of industry participants, commercial customers and trade associations. We would like to thank all those who were involved in this research.

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December 2007

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EXECUTIVE SUMMARY

The Financial Services Authority (FSA) asked CRA International (CRA) to examine the question of whether commission transparency (or lack thereof) within the commercial general insurance market leads to market failure and whether a mandatory commission disclosure regime (as opposed to the current "on request" disclosure) would generate benefits greater than the costs of intervention. The first phase of our work examined whether there was evidence of market failure, whilst the second phase consisted of a high level cost benefit analysis of different scenarios for mandatory commission disclosure.

In order to investigate these issues CRA has sought information on how the commercial insurance market works today and how it would change under mandatory commission disclosure. This involved:

- Detailed interviews with trade associations, insurers and intermediaries. In all 53 interviews were undertaken;
- Twelve detailed case studies of commercial insurance customers;
- A telephone-based survey of over 200 commercial customers with annual turnover of less than £100 million;
- Two workshops, one with insurers and the other with intermediaries, to develop and test mandatory commission disclosure scenarios;
- A survey conducted by the FSA of six trade associations;
- A survey of compliance costs from different mandatory disclosure regimes, resulting in 57 completed submissions; and
- An extensive review of the existing literature regarding commercial insurance, including the European Commission's interim and final reports on business insurance.[1]

We found evidence of market failure in a segment of the market accounting for about 10% of UK employers.[2] However, the extent of market failure due to non-disclosure is limited because intermediaries accounting for around 50-60% of this segment of the commercial

1 Sector Inquiry under Article 17 of Regulation (EC) No 1/2003 on business insurance (Final Report), European Commission, September 2007.

2 Throughout this report we use the standard economic definition of "market failure" to mean where markets do not function efficiently. The FSA definition of market failure (set out in "A Guide to Market Failure Analysis and High Level Cost Benefit Analysis, November 2006") defines market failure as occurring when there is an economic case for regulatory intervention. The FSA differentiates between a market failure, where regulatory intervention could be beneficial, and a market imperfection.

insurance market (as measured by either clients or gross written premium), already disclose remuneration to their clients.

The main benefit of a mandatory disclosure regime would be a reduction in insurance premiums to clients as a result of reduced intermediary remuneration arising from increased competition after disclosure. The one-off cost to the industry of a mandatory disclosure regime would be £87 million and the ongoing cost £34 million with costs primarily falling on smaller intermediaries. We do not believe that the quantum of benefits would exceed the costs of the regime. We therefore conclude that regulatory intervention in the form of mandatory commission disclosure alone cannot be justified on cost benefit grounds.

Market Failure Analysis

The UK commercial insurance market has three broad segments, each with different characteristics in terms of customer sophistication and type of intermediary. In two of these segments we find little evidence of market failure:

- Micro-enterprises (companies with turnover less than £500,000): These customers account for around £3 billion gross written premiums (GWP) or 17% of the market. The lack of sophistication amongst these buyers increases the risk of an informational market failure. However, 50% of these companies already purchase directly from insurance companies using the internet or by telephone rather than via an intermediary. The strong growth of the direct channel and the withdrawal of intermediaries serving this segment will continue to mitigate potential problems of non-disclosure. Clients who use an intermediary are able to compare the gross premium with that in the direct channel preventing detriment arising from high prices. We do not believe that market failures in this segment are substantive.

- Large corporate customers (LCCs - companies with annual turnover greater than £100 million): These customers account for around £5.5 billion GWP or 31% of the market. Large customers typically use fees and employ risk managers – which reduces the potential for information asymmetries. They also have access to substitutes to traditional insurance such as captive insurance, self-insurance and alternative risk transfer products. They are mainly served by large international intermediaries who already disclose their remuneration. Given this disclosure and because there is competition on fees, we believe there are no substantive market failures in this segment.

We have, however, identified a “middle segment” of commercial clients (companies with annual turnover between £500,000 and £100 million) who are at risk of suffering detriment from non-disclosure. These customers account for around £9.1 billion GWP or 52% of the market. Clients in this segment do not typically pay fees to their intermediaries but instead intermediaries receive commission from insurers.

Clients in this segment are reliant on intermediaries because they have complex needs and substitutes to insurance such as captives are not viable alternatives. These clients rarely switch intermediary and typically believe that commission is around 10%, when in practice it is closer to 20%, suggesting that competition based on the cost of advice is not strong. These customers are also unaware of their intermediaries' frequent use of contingent commission, which introduces potential conflicts of interest. Although disclosure could reduce or eliminate many of these problems, one-third of clients are unaware of their right to ask for commission disclosure. Clients who are aware of their right to know intermediaries' compensation levels, rarely exercise this right suggesting a lack interest in this information.

Competition over gross premiums could mitigate any problems in intermediary remuneration, although it does not appear to overcome them. Competitive pressure varies over the insurance cycle – with clients paying more attention to gross premiums when they rise, but less attention when they fall. In addition, recent consolidation in the intermediary market would be expected to generate cost efficiencies, but has had no discernible impact on gross premiums. In well functioning competitive markets we would expect cost efficiencies to be passed onto customers through lower premiums.

We therefore conclude that there is a market failure in this middle segment resulting from non-disclosure. However, this only affects clients who do not already remunerate intermediaries with fees, do not actively compare prices with direct channels, and who are not currently disclosed to. We estimate that this segment represents around 10% of commercial clients. Consumer detriment will arise through higher commission and lower value products than in the absence of market failures.

High-Level Cost Benefit Analysis

The second phase of our work tested whether mandatory commission disclosure would resolve the concerns identified in the market failure analysis and would generate benefits greater than the costs of intervention. Mandatory disclosure can take a number of forms and four disclosure scenarios were developed with variants of two of these scenarios:

- Scenario 1: Mandatory disclosure of the existing requirements;
- Scenario 2: Mandatory disclosure of total remuneration payable to the primary intermediary including quantification of the maximum value of contingent elements as well as standard commission (where a variant requires the disclosure of this information to the insurer as well as the client);
- Scenario 3: Mandatory disclosure of total remuneration payable to intermediaries throughout the chain including the compensation of non-primary intermediaries not captured in Scenario 2 (where a variant requires the disclosure of some of the information post sale instead of pre sale); and
- Scenario 4: Disclosure of a "commission equivalent" by direct insurers. It was assumed that this scenario would only occur in addition to mandatory commission disclosure rather than a stand-alone scenario.

The analysis undertaken has assumed that the great majority of international business would be exempt from any regime.[3]

The work demonstrated that there were significant undesirable unintended consequences associated with most scenarios (involving switching to other forms of remuneration or introducing other intermediaries into a chain in order to avoid disclosure), leaving pre sale disclosure of total remuneration throughout the chain (Scenario 3) as the most viable option.

Quantification of the cost and benefits of Scenario 3

Scenario 3 would make clients aware of the total remuneration earned by their adviser(s), and of the existence of other intermediaries in a chain when it exists. However, the scenario would introduce significant compliance costs that are set out in Table 1 below.

Table 1: Compliance costs for scenario 3

		One-off	Ongoing
Intermediary	Incremental compliance cost (£ millions)	48.0	18.1
	As a % of Gross Written Premium	0.27%	0.10%
Insurer	Incremental compliance cost (£ millions)	39.0	16.3
	As a % of Gross Written Premium	0.22%	0.09%
Total	Incremental compliance cost (£ millions)	87.0	34.4
	As a % of Gross Written Premium	0.49%	0.19%

Source: CRA International

The compliance costs, when scaled up to the market, are estimated at approximately £87 million of one-off costs for both insurers and intermediaries and £34 million of ongoing costs. These costs fall roughly evenly between insurers and intermediaries. When we combine the one-off costs with the ongoing costs we find that these costs would represent around £51 million per year or 0.3% of gross written premiums.[4]

These costs do not fall evenly across different intermediaries. Large international intermediaries have a relatively low cost of complying with the scenario as they: already disclose commission; do not accept contingent commission; and are often acting as the only intermediary in a chain. Hence smaller intermediary firms face proportionately larger compliance costs.

3 In line with the ICOB regulations it was assumed that mandatory commission disclosure is required only when the intermediary in contact with the customer is FSA authorised, the commercial customer is habitually resident in the EEA and for general insurance contracts, the risk is located in the EEA.

4 This is based on spreading the one-off costs over five years and adding this to the ongoing costs (0.5%/5+0.2%).

The important question is whether these costs are likely to be exceeded by benefits from reducing market failures. The main benefit from disclosure would be enhanced competition amongst intermediaries leading to a reduction in remuneration levels, which would be reflected in lower gross premiums.

It is important to note that the benefits from mandating commission disclosure can only arise where such disclosure does not *already* occur; where market failures associated to a lack of commission disclosure have been identified; and for those customers who act on any information provided.

In Table 2 below we show that commissions would need to fall by between 29% and 36% within the affected segment of the market in order for benefits to equal compliance costs.

Table 2: Quantification

	Calculation
Total compliance costs [a]	£51 million
Total GWP of UK commercial insurance business [b]	£17.7 billion
Proportion of GWP in the middle segment (where market failures have been identified) [c]	52%
Proportion of middle segment customers who do not already receive commission disclosure [d]	40-50%
Proportion of customers expected to act on commission information [e]	19%
GWP of middle segment customers who could benefit from commission information [f] = [b]*[c]*[d]*[e]	£700-875 million
Average remuneration [g]	20%
Remuneration in affected segment [h]=[f]*[g]	£140-175 million
Necessary fall in remuneration from commission disclosure among those customers who would be affected [j] =[a]/[h]	29%-36%

Source: CRA International

However, it is not clear from the evidence that mandatory disclosure would achieve the required impact on commission rates. Evidence from intermediaries regarding the likely impact on commission suggests that a reduction of 10% within *this segment* of clients is more likely.[5]

Furthermore, our calculations do not take into account any potential loss in service by intermediaries in response to a decline in price or because of a switch to the direct

5 It is also possible to examine this result at the level of the whole market rather than only the affected segment. Intermediaries estimated that the impact across the whole market would be a reduction of less than 0.5% of remuneration. With an average rate of remuneration of 20% of premiums, this would translate into a reduction of less than 0.1% of GWP. This is clearly less than the estimate of compliance costs of 0.3% of GWP.

channel, or a reduction in intermediaries developing new products. In addition, there are a number of detrimental market impacts that could arise leading to a reduction in the quality and variety of products available for clients. For these reasons we conclude that, based on the evidence gathered for this report, the cost of mandatory commission disclosure would outweigh the benefits.

1. INTRODUCTION

CRA International (CRA) was asked by the Financial Services Authority (FSA) to investigate the commercial general insurance market in order to understand whether there is any market failure related to a lack of disclosure of commission arrangements and to undertake a Cost Benefit Analysis (CBA) of mandatory commission disclosure. The FSA set out the following objectives:

- The aim of this project is to assess the extent to which commission transparency (or lack thereof) within the wholesale/commercial general insurance market leads to inefficiencies and/or consumer detriment.

- This will involve the production of an objective Market Failure Analysis (MFA) and Cost Benefit Analysis (CBA) covering transparency both to the consumer and the wider market:

    - The MFA will seek to identify any substantive market failure that arises from existing disclosure practices;[6] and

    - The CBA will seek to measure the impact on customers of mandating commission disclosure.

1.1. THE CURRENT RULES

Currently, intermediaries only have to disclose commission if they are requested to do so by their client. The ICOB rules state,

> *"Before the conclusion of a non-investment insurance contract, or at any other time, an insurance intermediary that conducts insurance mediation activities for a commercial customer must, if the commercial customer asks, promptly disclose the commission that he and any associate of his receives in connection with the non-investment insurance contract in question, in cash terms or, to the extent it cannot be indicated in cash terms, the basis of the calculation of the commission, in a durable medium." [ICOB 4.6.1 R]*

In addition the guidance in ICOB states that commission disclosure:

- Does not apply to an insurance intermediary that is an insurer i.e. there is no obligation to disclose a "commission equivalent" [ICOB 4.6.3 G];

- Is not required throughout the whole distribution chain [ICOB 4.6.6 G]; and

6 Through out this report we use the standard economic definition of "market failure" to mean where markets do not function efficiently. The FSA definition of market failure (set out in "A Guide to Market Failure Analysis and High Level Cost Benefit Analysis, November 2006") defines market failure as occurring when there is an economic case for regulatory intervention. The FSA differentiates between a market failure, where regulatory intervention could be beneficial, and a market imperfection.

- Should include all forms of remuneration (including profit and volume related commission and premium finance) [ICOB 4.6.7 G].

The rules apply to non-investment insurance contracts with commercial customers but do not apply to "contracts of large risks".[7]

1.2. METHODOLOGY

In order to investigate whether there is any market failure related to a lack of disclosure of commission arrangements and to undertake a CBA of mandatory commission disclosure, we have sought information on how the commercial insurance market works today and how it would change under mandatory commission disclosure. This involved:

- Detailed interviews with trade associations, insurers and intermediaries. In all 53 interviews were undertake;
- Twelve detailed case studies of commercial insurance customers;
- A telephone-based survey of over 200 commercial customers with annual turnover of less than £100 million;
- Two workshops, one with insurers and the other with intermediaries, to develop and test mandatory commission disclosure scenarios;
- A survey conducted by the FSA of six trade associations;
- A survey of compliance costs from different mandatory disclosure regimes, resulting in 57 completed submissions; and
- An extensive review of the existing literature regarding commercial insurance, including the European Commission's interim and final reports on business insurance.[8]

1.2.1. Interviews with intermediaries and insurers

Interviews were undertaken with a wide range of intermediaries and insurers in order to test for the existing of a market failure and to assess the likely impact of mandating commission disclosure. In total we estimate that we interviewed firms responsible for over 70% of both the insurance and intermediary markets. Insurers included those who are active in the company market as well as those that write insurance business through the Lloyd's market and covered insurers of different sizes as well as insurers who focused on particular lines of business or distribution methods.

7 See FSA Handbook for the definitions of commercial customers and contracts of large risks.

8 Sector Inquiry under Article 17 of Regulation (EC) No 1/2003 on business insurance (Final Report), European Commission, September 2007.

Similarly intermediary interviews were held with the large international intermediaries, other large national intermediaries, smaller regional intermediaries, and Lloyd's brokers. These included interviews with firms that are client-facing or primary intermediaries as well as those that operate as wholesale intermediaries.

All of the interviews were aimed at understanding how different parts of the insurance and intermediation markets operate. Early interviews focused on identifying market failure issues whereas others focused on testing different scenarios for mandatory disclosure and the different market impacts that could result from these.

1.2.2. Case studies and client survey

The aim of both the client survey and the case studies was to understand the demand for insurance and intermediation services and to examine how this varies depending on the characteristics of the company buying the insurance.

Throughout the report we segment commercial clients according to their turnover and refer to the following categories:

- Micro-enterprises as companies with turnover of less than £500,000;
- Small to Medium Enterprises (SMEs) as companies with annual turnover between £500,000 and £100 million;[9] and
- Large corporate customers (LCCs) as companies with over £100 million annual turnover.

The use of this segmentation was supported by interview evidence and data from the client survey.

Case studies

The aim of the twelve case studies was to undertake in-depth interviews with customers regarding how they purchase different types of insurance products and the relationship they have with both their intermediaries and the provider of the insurance.

These interviews investigated how companies develop ongoing relationships with their intermediaries, how they monitor the value of these contracts, the range of services they use and the tendering process they use for large insurance contracts. Seven case studies were conducted with firms with a turnover of over £100 million and the remaining case studies were with smaller firms. The sectors covered by these firms included: aviation; communications; distribution; engineering; financial services; household goods; IT; professional services; and retailing.

9 This differs from the convention adopted in the European Commission's recent interim report on the business insurance sector. They differentiated between companies with less than 250 people and whose turnover was under €50 Million. Datamonitor adopt the DTI's categories with small companies having less 50 employees and medium sized companies having 50 to 250 employees.

The choice of companies was intended to reflect the different reasons that clients use intermediaries (such as search, risk management and claims handling) and their need for insurance. This involved identifying companies that would have different needs regarding issues such as: the complexity of advice and the sophistication of the client in being able to deal with these needs internally; whether insurance is compulsory; the repeat nature of some insurance needs; the use of intermediaries for services beyond insurance mediation; whether insurance represents a large cost relative to other costs of the business or is an intrinsic part of the business activity; and any need for international diversification.

The interviews were undertaken on a confidential basis.

Client survey

The telephone based client survey focused on micro-enterprises and SMEs. As with the case studies, the survey was aimed at understanding how commercial customers purchase insurance and intermediation services. In particular it aimed to understand:

- the degree to which clients impose competitive discipline on the market; and
- whether further information would be useful to clients, and whether its provision would change the way that they choose intermediaries or agree terms.

The survey was undertaken by Continental Research between 10th and 25th May and covered 203 respondents. The annual turnover of the companies ranged from £50,000 to £100 million. Table 3 provides the details of the types of companies that were included in the sample.

Table 3: Sampling frame

Category	Manufacturing	Distribution	Services	Total
£50-£500k	15	18	17	50
£500k-£5m	14	22	16	52
£5m-£20m	14	22	14	50
£20m-£100m	19	19	13	51

Source: CRA International

1.2.3. Trade association survey

A further source of input was a survey, undertaken by the FSA, of the following 6 trade associations:

- The Association of British Insurers (ABI);

- British Insurance Brokers' Association (BIBA);
- Institute of Independent Brokers (IIB);
- Insurance Underwriters Association (IUA);
- Lloyd's Market Association (LMA); and
- London Market Insurance Brokers' Committee (LMBC).

The trade association survey was designed both to capture qualitative and quantitative data detailing key aspects of both the market and individual firms. Trade associations were asked to complete the qualitative questionnaire and identify respondents for the quantitative section of the survey.

1.2.4. Workshops

In order to conduct the CBA, different scenarios of mandatory commission disclosure were designed. As this represents a high level CBA, the objective was to develop a range of possible scenarios rather than to set out detailed rules regarding how a particular scenario would work.

The scenarios were developed in discussion with the FSA and in two workshops: one with insurers (including Lloyd's syndicates and large insurers); and one with intermediaries (including nationals, large and small intermediaries from both the regional and London market).[10] Following the workshop, four scenarios (with two variants) were tested during the CBA stage of the work.

1.2.5. Compliance cost survey

A compliance cost survey was designed in order to gather information on all of the scenarios of mandatory commission disclosure and was sent to a cross section of intermediaries and insurers. The survey focused on capturing data on incremental costs associated to the various scenarios and the underlying assumptions regarding the market impacts of disclosure. In all 101 questionnaires were sent out (43 insurers and 58 intermediaries) and 57 were completed (22 insurers and 35 intermediaries).

1.3. Structure of the report

The rest of this report is structured as follows:

- In chapter 2, we consider how, in theory, a lack of commission transparency in commercial general insurance might lead to market failure.

10 The workshops took place on 27 July, 2007.

- In chapter 3, we analyse the supply of commercial general insurance: the players, the products and the distribution chain.
- In chapter 4, we look at the demand for commercial general insurance: who buys it and how.
- In chapter 5, we present our overall conclusions on whether there is a market failure.
- In chapter 6, we assess the potential for different mandatory disclosure regimes to address these market failures and result in net economic benefits.

2. POTENTIAL SOURCES OF MARKET FAILURE

In this chapter, we consider the types of market failure that could arise from a lack of transparency regarding remuneration for insurance intermediation in the commercial insurance market and the types of evidence that would shed light on whether this was causing consumer detriment.

At the beginning of the FSA's review it noted that there had been calls for the FSA to mandate the disclosure of commission. The varying aims given by market participants were to:

- ensure a level playing field between those brokers who have chosen routinely to disclose to customers and those who do not;
- improve transparency to commercial customers to ensure they receive information about commission paid; and
- improve market transparency, in particular by introducing disclosure to insurers in a way that allows them to see how commission is earned throughout the distribution chain – and so facilitate a downward pressure on costs leading to greater efficiency and competition.

Below we set out the main role of an insurance intermediary from a theoretical perspective and then describe the types of market failure that may arise in such an intermediated market. One of the major potential sources of market failure in these sorts of markets stems from asymmetric information, although other features such as bargaining power will also be considered below.

In the chapters that follow we consider the evidence on whether the potential problems highlighted here result in substantive consumer detriment.

2.1. INSURANCE INTERMEDIATION AND ASYMMETRIC INFORMATION

Broadly speaking, commercial customers take out insurance because they would prefer to face a certain but small loss (in the form of their premium), rather than an uncertain but large loss (in the form of the detriment suffered from a particular risk).[11] However, the actual risks faced, the likelihood of those risks and the severity of risks, particularly in the commercial market, may be difficult to predict and therefore the decision regarding the purchase of insurance that is required is often complex.

11 In some cases the law may impose additional requirements for insurance that a company may not otherwise have taken out.

2.1.1. Customers and asymmetric information

Commercial customers face a complex choice when buying insurance. Risks can vary significantly between one customer and the next and the insurance designed to cover these risks will often be bespoke. As such, a customer will need to consider not only the price (or premium) they are being asked to pay, but also the coverage. Other important dimensions include the reputation of the insurer with respect to factors such as promptly paying claims and financial strength.

Customers suffer from asymmetric information because they do not know as much about insurance as do the insurers themselves. In order to overcome this problem some commercial customers will employ internal experts in the form of risk managers, but most firms will rely on using the services of an insurance intermediary. Typically, firms that employ risk managers will also still choose to use intermediaries, especially in complex insurance markets.

2.1.2. Insurers and asymmetric information

The asymmetry of information is not one way. Insurers depend on information about customers and the risks they face in order to set a price that fairly reflects the chance of a loss. When insurers cannot determine the nature of a risk then the market may become inefficient or, in the worst case, disappear.[12] However, intermediaries can play a valuable role in overcoming this particular form of asymmetric information and making insurance markets more efficient.[13]

Intermediaries often have close, long-standing relationships with clients, which allows them to gather detailed information on the risks faced by clients at a much lower cost than would be the case for an insurer. This brings benefits to clients because the intermediary can choose the most suitable cover for the client. It also benefits the insurer, who is provided with better information in order to set the most appropriate price. Hence the intermediary may effectively be acting on behalf of both the client and the insured.

2.2. Remuneration and asymmetric information

As noted above, because customers suffer from asymmetric information with respect to the insurance market, many rely on the services of an intermediary. However, the result of using an intermediary is that once again the client suffers from asymmetric information, but this time it is the intermediary who has more information than the client.[14]

12 See Rothschild, Michael and Joseph Stiglitz. (1976) "Equilibrium in competitive insurance markets: an essay on the economics of imperfect information" *The Quarterly Journal of Economics*, Vol. 90, No. 4, pp. 629-649.

13 See Cummins, J. David and Neil A Doherty. (2006) "The Economics of Insurance Intermediaries" *The Journal of Risk and Insurance,* Vol. 73, No. 3, pp. 359-396.

14 Indeed this is one of the primary characteristic that makes them valuable to their clients – were they not to have greater information regarding the insurance market then clients would not gain from using them.

The particular aspect of asymmetric information that is the focus of this report is whether commercial customers understand the remuneration that the intermediary receives and the different incentives that arise when intermediaries are paid commission by the insurance companies who provide the cover for the client. Customers could, of course, choose to pay their intermediaries through fees (which would not be related to the particular insurance company providing the cover). There are a number of reasons why clients might choose to pay by commission instead of fees. For example, many clients are reluctant to pay for intermediation services if they do not take out any insurance cover. In addition, if customers pay through fees then this would make comparing the services of different intermediaries more costly as they would have to pay multiple fees.

Where clients pay via commission there are two potential concerns regarding the lack of transparency.

First, client confusion regarding the role of the adviser compared to the role of the provider of the insurance and regarding the separation of the payment for the intermediary's service can result in a lack of price transparency. This could cause clients to underestimate the cost of intermediary services leading them to over pay or over consume. In the extreme, some clients may also perceive intermediation to be free because they do not see a separate price associated to the intermediary services. This lack of price transparency may reduce the incentive for the client to shop around for the best value product with the result that clients receive lower value products than they otherwise would.

Second, the client is also not able to monitor the behaviour of the intermediary and so there is a danger that the incentives of the intermediary are not always aligned with the incentives of the customer (known as the "principal-agent" problem).

The use of commission may incentivise the intermediary to act in a number of ways which are not in the best interest of the client. This could take a number of forms:

- Bias to sell: Commission based remuneration can bring about a bias to sell because when using this form of remuneration, intermediaries are only paid when a sale is made. Within the commercial insurance market this could include: persuading clients to take out insurance rather than considering self insurance or taking steps to mitigate a risk; and selling a greater quantity of insurance through recommending higher levels of coverage. These problems are less severe when there is a requirement to purchase insurance and the amount of insurance has been pre-determined.

- Provider bias: Provider bias arises when intermediaries recommend a particular insurer because of the level of commission the intermediary will receive. Connected to the issue of provider bias is the potential for intermediaries to recommend a particular provider because of features of the reinsurance process. It is possible that intermediaries will recommend insurance companies where the intermediary is confident that they will be asked to place the reinsurance business (and so gain additional commission) in preference to those insurance companies who would not do this.

- Product bias: It is possible that differential commission rates across different products could provide incentives to sell the wrong type of insurance because the intermediary can earn a higher level of commission from doing so. Where intermediaries are assisting clients in assessing their need for insurance this provides the potential to recommend cover for one type of risk rather than another that may be more appropriate for the client.

In addition to the potential for the previous three forms of bias to arise because of "standard" commission payments, these incentives may be exacerbated by the presence of "contingent commission". There are two main forms of contingent commission. Profit based commission – where the commission received by the intermediary is based on the profitability of the book of business that they place with a particular insurer and volume based commission – where the commission received by the intermediary is based on the volume of business that they place with a particular insurer.[15]

It should be noted that we have focused on qualitative evidence regarding the existence of bias. Statistical analysis testing for the existence of bias was outside the scope of this assignment.

2.3. Factors affecting the extent of market failure

Although the issue of remuneration is the main focus of this report, other characteristics of the market will impact on the extent of any market failures associated to remuneration. The characteristics that are considered in this section relate both to the demand side and to the supply side.

Demand side issues include:

- Client sophistication – sophisticated clients will be aware of different types of remuneration used to pay intermediaries, the incentives these lead to, and can therefore take action to mitigate any concerns such as by employing risk managers. Less sophisticated clients may not be aware that intermediaries receive commission or understand the incentives that their intermediary faces because of this.

15 Volume based commission can work in two different ways. Forward looking incentives where the insurer agrees to pay the intermediary a higher level of commission on the additional business written over a particular threshold or backward looking incentives where the insurer agrees to pay the intermediary a higher level of commission on the total business written in a year if a particular threshold is exceeded. This has a much larger incentive effect at the threshold because the marginal commission rate at the threshold can be substantial.

- Shopping around and switching costs –when clients shop around both intermediaries and insurers face competitive pressure to offer improved terms in order to capture the client's business. However, shopping around will be reduced when there are high switching costs such as the need to educate the intermediary about the client's business. Shopping around could arise for both the intermediation service and the insurance cover.[16]

- Understanding the activity of the intermediary – in order to be able to assess whether the services of the intermediary are value for money clients need to understand the activities that their intermediary is providing. However:

  - Clients may not be able to monitor the amount of search that intermediaries perform and search imposes costs on the intermediary, but brings benefits to the client;

  - Clients may not know whether intermediaries use another intermediary to access particular market and whether the use of such "chains" represents efficient specialisation or duplication of costs;

  - Clients may not know whether payments for activities performed by the intermediary on behalf of the insurer are leading to efficiency gains or simply represent a way of gaining additional remuneration; and

  - Clients purchasing through (and overpaying for) an intermediated channel when they believe they are purchasing direct or vice versa.

Supply side issues include:

- A distortion of competition between intermediaries who disclose their remuneration (demonstrating that intermediation is not free) and those that do not (where some clients may believe that they are receiving a free service).

- Bargaining power - the relative strength of clients, intermediaries and insurers will impact the extent to which market failures occur. In particular, if the intermediary has bargaining power with insurers, they could be able to secure better terms for their clients and reduce asymmetries of bargaining strength between insurers and clients. Alternatively, if they have bargaining power with clients they may be able to retain the gains from this process for themselves rather than passing the gains onto clients.

16 Clients may be less willing to shop around if they believe that they are already getting a good value and high quality service from their existing intermediary and insurer. A low level of shopping around could therefore reflect high switching costs or a high level of satisfaction.

- Long-term contracts – in the commercial insurance market contracts will arise between: clients and insurers; clients and intermediaries; and insurers and intermediaries. In each case, the longer the average contract length the fewer the number of contracts that come up for renewal and therefore the weaker the ability for new entrants or other competitors to gain market share by offering better value products.

The different characteristics identified in this section form part of the assessment of how the market operates in chapters 3 and 4 and feed into the conclusions of whether there are market failures in chapter 5.

3. SUPPLY OF INSURANCE AND INTERMEDIATION

In this chapter, we examine the supply of commercial insurance in the UK both in terms of the provision of insurance and intermediary services, although given the scope of the report the focus is on intermediaries and their remuneration. Chapter 4 examines the demand for insurance and intermediation.

Section 3.1 sets out a summary of the key findings. Section 3.2 gives an overview of the insurance and intermediation value chain in order to set out the way in which commercial insurance is distributed to end clients. Section 3.3 provides a high level description of the insurance market. Section 3.4 provides details on the role of the insurance intermediary and the structure of the intermediation market. Section 3.5 examines intermediary remuneration in detail and considers the different types of remuneration that may arise and where these may lead to incentives that could give rise to market failure.

The analysis presented here focuses on whether a lack of transparency regarding remuneration results in market failure. We have primarily focused on factors that affect the whole of the insurance or intermediation market and only provide a high level review of different types of insurance.[17]

3.1. SUMMARY OF KEY FINDINGS

Based on the evidence from interviews, the trade association survey, data provided by market participants and other background research, the main conclusions from this chapter are as follows:

1. The value of Gross Written Premium (GWP) in the commercial market is estimated at around £17.7 billion with around 1.3 million UK employers purchasing insurance.

2. Within the UK insurance market we can distinguish between the Lloyd's market and the company market. Although there are differences between Lloyd's and the company market, there are many areas where they compete directly with one another.

3. Competitive discipline can arise due to competition within the intermediary channel or by clients choosing to go direct to an insurance company. Within the company market, insurance is mainly distributed through the intermediary channel, although almost 10% is delivered directly by the insurer – mainly focused on micro-enterprises. It is expected that withdrawal of intermediaries will continue to arise in the part of the market serving small companies.

4. In contrast, access to the Lloyd's market is only possible through an accredited Lloyd's broker and is therefore all intermediated. The majority of clients and primary

17 It is possible that there may be market failures that are not associated to the disclosure of information relating to remuneration or that arise in only some parts of the insurance and intermediation markets that have not been identified.

intermediaries providing business to the Lloyd's market are overseas and therefore not within the jurisdiction of the FSA.

5. There has been considerable consolidation in both the Lloyd's syndicates and the company market. However, the prevalence recent entrants suggest that barriers to entry are not high.

6. In terms of the provision of intermediary services, we distinguish between the London market and a regional market. The London market refers primarily to international and large corporate business and is mainly served by the international intermediaries. The regional market refers primarily to business with micro-enterprises and SMEs and there is a wider range of competitors in this space although the international intermediaries also compete in this market.

7. The regional intermediation industry has seen considerable consolidation in recent years. This has resulted in greater work transfer and vertical integration of intermediaries. However there is no evidence that the efficiency gains from this process are being passed onto clients in terms of lower premiums.

8. Chains remain relatively common in the UK market. These occur when intermediaries use other intermediaries in order to access the insurance required. These chains do not tend to be long and there are constraints imposed on their length because of a reluctance to split remuneration with another intermediary and a desire by insurers to control the risks of long chains. There is also evidence that vertical integration is leading to a reduction in the length of chains.

9. In terms of remuneration, intermediaries are paid primarily by standard commission, contingent commission, and fees. Commission averages around 20% but varies by type of customer, intermediary and category of insurance.

10. Contingent commission is a common feature of the market and is paid by the majority of insurers to many of the larger intermediaries (excluding the three largest intermediaries who do not accept contingent commissions because of the Spitzer investigation). Although volume based and profit based contingent payments typically each represent only 3% or 4% of total revenues earned on small clients, in some cases intermediaries could potentially receive large contingent payments.

11. The role of profit based commission is especially important where intermediaries have binding authorities or are acting as a Managing General Agent. It also provides one of the incentives for intermediaries to "make markets".

12. Work transfer arrangements where intermediaries undertake work on behalf of the insurer add complexities as it may be unclear whether remuneration paid by the insurer to the intermediary is to reflect work done on behalf of the client or the insurer.

13. Approximately 50-60% of the market already provides commission disclosure automatically. The rest of the market has introduced manual processes to deal with requests by clients regarding the level of remuneration but they receive very few requests each year.

3.2. OVERVIEW OF DISTRIBUTION

Before examining the detail of the insurance and intermediation markets, it is useful to set out in broad terms how insurance is delivered to the end client in order that the remainder of the chapter can be put into context. This is especially useful because the UK has an unusual position in respect of insurance markets due to the presence of Lloyd's. The commercial insurance market is therefore often described as splitting into two markets:

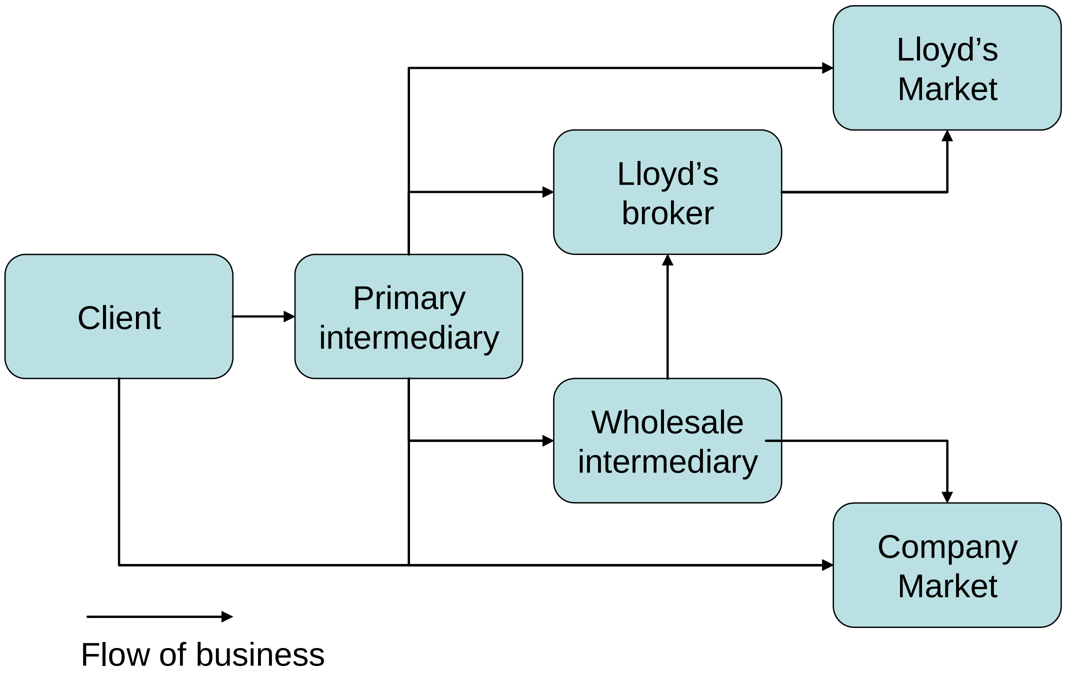
- Lloyd's market; and the
- Company market.

It should be noted that although these will be referred to as "markets" that is not to say that they represent different economic markets since many risks could be insured through either of these markets and companies operating in these markets compete with each other to provide insurance services (indeed some companies operate in both).

Figure 1 below provides a simplified illustration of how insurance is distributed to clients. Among other factors, the distribution of insurance will depend upon whether:

- The client deals with the company market direct or uses an intermediary;
- The client-facing or primary intermediary has direct access to the insurer or uses a secondary (or possibly tertiary) intermediary in order to gain this access; and
- The insurance cover is provided by the company market or the Lloyd's market.

Figure 1: Illustrative distribution of insurance



Source: CRA International

Each of these different routes to accessing insurance will lead to competitive pressure arising in different areas. Clients choosing to go direct to an insurance company impose a competitive restraint on those intermediaries who serve similar customers.

Figure 1 also illustrates the possibility of what are known as "chains". If the primary intermediary is itself a Lloyd's broker, it could directly access the Lloyd's market.[18] However, an alternative is that the primary intermediary uses a wholesale intermediary who then uses a Lloyd's broker who then accesses the Lloyd's market thereby forming a chain of intermediaries. There are a number of reasons why such chains might exist that are explored in section 3.4.4 below.

3.3. INSURANCE

3.3.1. The Lloyd's market

Lloyd's is not itself an insurance company, but rather is a collection of both corporate and individual members.[19] The members provide the capital required to offer underwriting and conduct their insurance business in "syndicates". There has been significant consolidation among syndicates where the number has shrunk from 400 in 1980 to 72 in 2007. The syndicates may focus in particular areas of insurance but they compete against each other for insurance business. Despite this consolidation, the Lloyd's market remains relatively fragmented with the largest ten syndicates responsible for around 50% of capacity at Lloyd's.

The syndicates are run by 47 "managing agents", who employ and supervise the underwriters who contract the business of the syndicate. Managing agents must be a company specifically established for the purpose of managing a syndicate and is not allowed to perform any other function.

The underwriters who are employed by the managing agents on behalf of the syndicates do not deal directly with clients, but instead deal through specially accredited intermediaries. There are currently 167 accredited firms of intermediaries who may do business at Lloyd's. A non-accredited intermediary must contact a Lloyd's broker in order to access the Lloyd's market.

The Lloyd's market is a subscription market, where each underwriter may subscribe (on behalf of a syndicate) to a portion of the total risk.[20] The terms of the deal are typically

18 Only Lloyd's brokers can access the Lloyd's market – see section3.3.1.

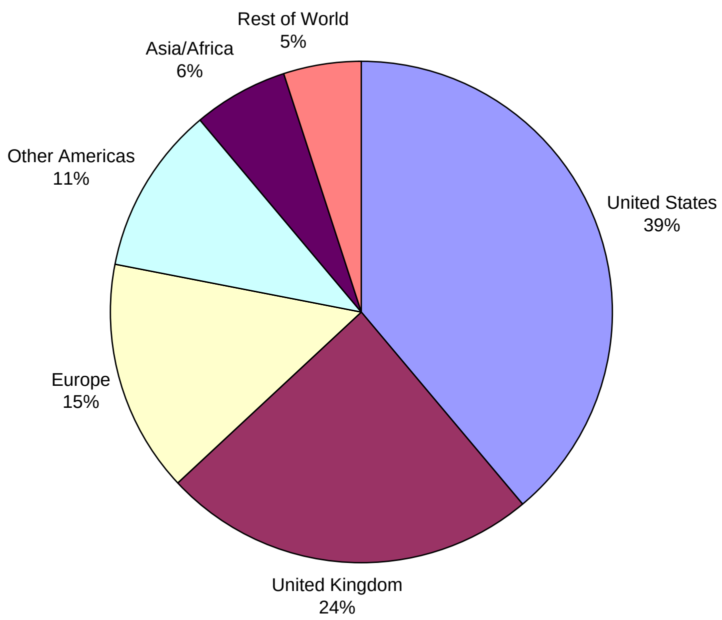
19 Details in this section come from a combination of the Lloyd's website, Lloyd's Annual Report 2006 and Lloyd's Factsheet, August 2007.

20 Sharing of risks may also happen in the company market. This could happen through "co-insurance" or because large risks are split into "layers" with different insurance companies taking on the risks for different values of insurance e.g. one insurer may provide cover for loss of £100 million to £200 million, with another insurer providing cover for the layer between £200 million and £300 million on the same risk.

negotiated between the intermediary and the "lead underwriter" with the lead underwriter insuring any amount between 5% and 100% of the risk. This is typically done through using the "slip" on which the underwriters will mark the proportion of the risk that they are willing to take. The intermediary then approaches other underwriters to cover the remainder of the risk. If the intermediary is unable to cover 100% of the risk based on the original terms, then the intermediary may need to re-negotiate the terms until the point where the risk is fully subscribed or the slip is filled i.e. 100% of the risk is covered.

Lloyd's is best known for providing insurance for complex and specialist risks. Due to its specialist nature Lloyd's attracts business from across the world. For example, it is estimated that Lloyd's represents approximately 10-15% of the world's reinsurance and large commercial insurance business, including around 15% of all marine business, 27% of world aviation insurance and as much as 60% of all energy business.[21] Indeed, this is reflected in the breakdown of customers by region in Figure 2 below.

Figure 2: Lloyd's business by region (2006)



Source: Lloyd's Annual Report 2006.

Overseas customers account for more than three-quarters of the overall business placed within Lloyd's. Domestic UK business represents only 24% of the value of business conducted at Lloyd's. With Gross Written Premiums of over £16 billion, the value of business written for UK customers is around £3.9 billion.

The majority of clients and primary intermediaries providing business to the Lloyd's market are in overseas territories not within the jurisdiction of the FSA.

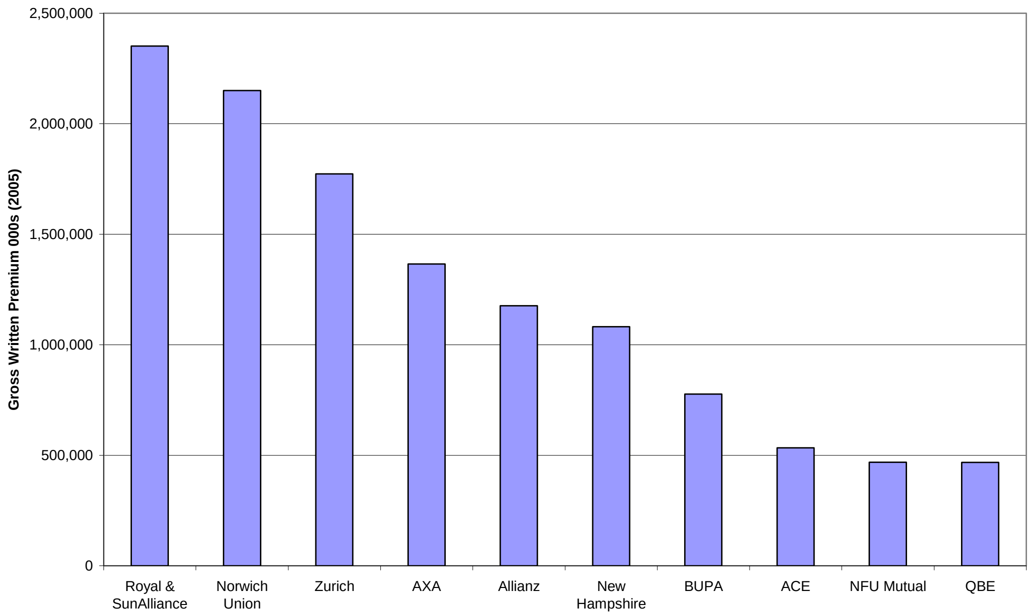
21 Sector Inquiry under Article 17 of Regulation (EC) No 1/2003 on business insurance (Interim Report), European Commission, January 2007.

Lloyd's underwrites a variety of types of risk. In 2006, reinsurance was the largest category of risk representing 34% of business in Lloyd's, followed by casualty and property (22% each).

3.3.2. Company market

According to FSA figures there were 788 general insurance companies operating in the UK as at March 2007.[22] It is estimated that the top ten commercial insurance groups account for around 70% of the market of £17.8 billion.[23] Figure 3 below shows the gross written premium for the largest ten providers.

Figure 3: Top 10 insurers by gross written premium (latest figures available in 2006)



Source: UK Commercial General Insurance 2006, Datamonitor

The commercial insurance market encompasses a wide variety of insurance products, from those which every company must purchase by law, such as employers' liability insurance, to highly specialised products tailored to a particular company.

3.3.3. Estimate of market size

We have estimated that the total size of the insurance market for the purposes of our research is approximately £17.7 billion of GWP.

22 FSA Annual Report 2006/07.

23 UK Commercial General Insurance 2006, Datamonitor. Note that this may include insurance for non-UK risks.

According to ABI figures, GWP of UK commercial lines business represented £15.1 billion in 2005 (the latest year for which these figures are available).

However, this figure does not include business written through the Lloyd's market. As noted in section 3.3.1 above, the value of business written for UK customers is around £3.9 billion. Some of this will be reinsurance business which would currently be excluded from the scope of ICOB. Indeed, we have noted that approximately 34% of the Lloyd's market is reinsurance. We therefore estimate that the value of UK, non-reinsurance business is approximately £2.6 billion of GWP.

Adding the estimate of £15.1 billion GWP for UK commercial lines business from the ABI along with the £2.6 billion GWP from Lloyd's gives a total of £17.7 billion. We use this figure of £17.7 billion as the estimate of the market size throughout the calculation of costs and benefits in chapter 6.

3.3.4. Competition in insurance

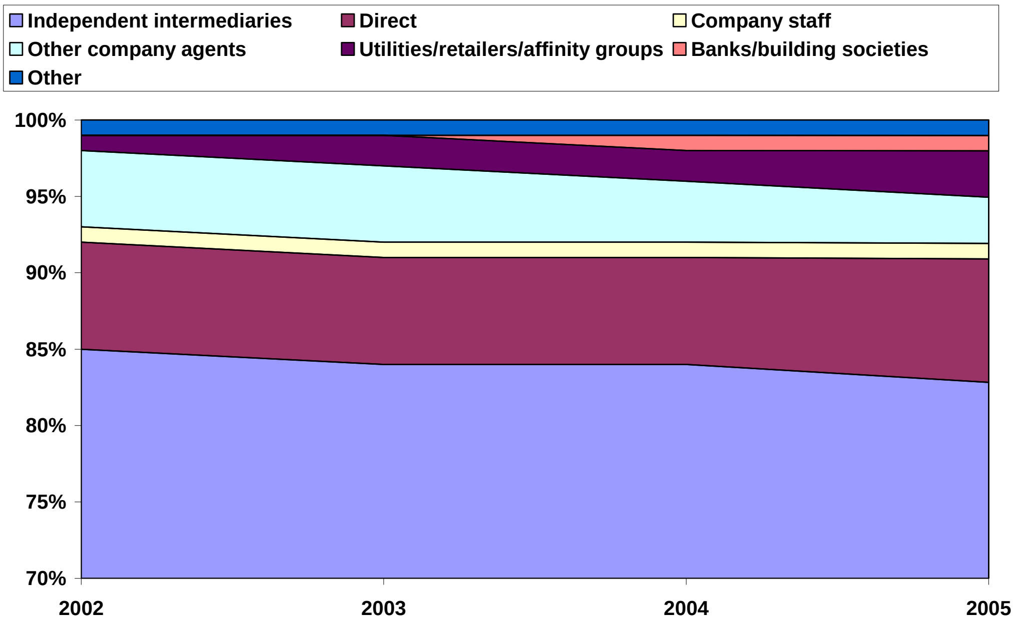
Although there are clear differences between Lloyd's and the company market, there are also many areas where they compete directly with one another.

Distribution of insurance

As noted above, all of the business written at Lloyd's has to access the Lloyd's market through an approved Lloyd's broker.

In the company market, as can be seen in Figure 4 below, commercial insurance is largely distributed through independent intermediaries, which represents over 80% of business. The second largest channel is that of directly distributing insurance to clients which in 2005 represented around 8% of business.

Figure 4: Distribution of general insurance



Source: ABI General Insurance Statistics

Intermediaries place competitive pressure on different insurance companies as they search the market on behalf of their clients. We consider this issue in section 3.4 below where we examine the role and services that intermediaries provide to their clients. Competitive issues driven by the demand side are examined in chapter 4.

Given that many clients use intermediaries when purchasing insurance, this means that insurance companies may compete for intermediaries rather than for the end clients. In particular, they may compete for intermediaries by paying higher levels of commission to intermediaries that they wish to attract such as those that place high volumes of business or highly profitable business.

Competition is imposed on intermediaries by the alternative approach of clients going direct to insurance companies. As is seen above, this has grown slightly over recent years and, according to interview evidence, the direct channel is expected to continue to grow. As explained further in Chapter 4, however, the direct channel is mainly used by small commercial clients.

Consolidation of insurance companies

There has been consolidation in the insurance sector over recent years. According to ABI statistics, the number of UK insurers authorised to conduct general insurance has fallen by around 15% over the past ten years. In part this is due to mergers and acquisition of which there were 47 in the period 1997-2005.[24] FSA figures indicate there has been a reduction in the number of general insurance companies operating in the UK from 836 in March 2006 to 788 in March 2007.[25]

As noted in section 3.3.1, there has been considerable consolidation in the Lloyd's market with the number of syndicates declining from 400 in 1980 to 72 in August 2007.

Profitability and barriers to entry

According to the EC, entry into the insurance market is mainly determined by the expected profitability of the market or line of business and by the potential for growth of the market.[26]

However, profitability in the commercial insurance market is highly cyclical. Indeed, market participants will often talk about the "underwriting cycle" which impacts both profits and also premiums. This is because the supply of insurance is driven by a number of factors including shocks caused by especially large losses, the impact of rates of return on invested premiums, and the availability of capital. The timing and amplitude of the cycle varies depending on the type of insurance under examination.

The presence of the underwriting cycle means that analysing information on the profitability of companies as a method of establishing the degree of competitiveness of a market becomes even more problematic than it is usually.[27] It is therefore easier to examine evidence on barrier to entry. The EC found that while the costs of distribution and access to distribution are important factors, regulatory barriers were not a major concern.[28]

One of the ways that the extent of barriers to entry can be assessed is by observing whether there has been actual entry. Datamonitor identified three underwriting agencies launched commercial offerings in 2006, specifically targeting smaller companies.[29]

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24 It is difficult to judge whether there has been a trend in the number of foreign insurers because it is believed that earlier figures suffered from an under-reporting of EEA companies. ABI General Insurance Statistics.

25 FSA Annual Report 2005/06 and 2006/07. The number of UK incorporated general insurance firms declined from 412 to 384.

26 The European Commission found this to be the case in the insurance market. Sector Inquiry under Article 17 of Regulation (EC) No 1/2003 on business insurance (Interim Report), European Commission, January 2007.

27 Furthermore the use of profitability information is limited when attempting to consider the impact of asymmetric information.

28 Sector Inquiry under Article 17 of Regulation (EC) No 1/2003 on business insurance (Interim Report), European Commission, January 2007.

29 These included ABC Insurance, M4 Underwriting and Arista insurance. UK Commercial General Insurance 2006, Datamonitor.

Indeed, within the Lloyd's market there has been an increase in the number of syndicates from 66 on the 1st January 2007 to 72 as at August 2007.[30] This increase in the number of syndicates does not suggest that barriers to entry are preventing new entry.

Although there is increasing concentration in the insurer and Lloyd's market, recent entry suggests that barriers to entry does not pose a problem.

3.4. INTERMEDIATION

This section of the report describes the intermediary market for commercial general insurance. The intermediary market also varies significantly depending on the services being provided by the intermediary, the activities the intermediary is undertaking on behalf of the insurer and the status under which they are acting.

3.4.1. Services provided by the intermediary to the client

There are a number of different services that intermediaries will offer to their client. The exact range of services will vary for individual clients and for individual intermediaries but in general include:

- Assisting clients in assessing their needs. This may include assessing the different risks that they face, the extent of the client's own willingness to bear that risk (i.e. to self insure) and therefore to identify their needs in terms of the risks for which insurance cover is required;
- Assisting the clients in identifying the appropriate supplier of insurance. This may involve searching the market, matching buyers with insurers who have the skill, capacity, risk appetite, and financial strength to underwrite the risk, and then helping the client to select from competing offers;
- Assisting in negotiating or designing the contract. One of the complexities of insurance contracts is that the details of the terms and conditions will frequently determine whether or not the contract provides the cover for exact events that arise and hence whether policy details match the client's understanding of what is, and is not, covered by the insurance;
- Provision of premium credit or instalment premiums. This is where the intermediary helps to facilitate the payment for insurance; and
- Assisting with payment of any claims. Intermediaries will often help clients to assess whether or not an event that has arisen is covered by the insurance contract and provide assistance in dealing with the insurance company in order to ensure that any payment is made promptly.

30 Lloyd's Annual Report 2006 and Lloyd's Factsheet, August 2007.

Information from the Trade Association Survey found that intermediaries provide similar services to both SME clients and large clients. The most frequently provided service was insurance placement.[31] Claims management was the second most frequently mentioned service and was provided by over 70% of intermediaries. Risk management and the provision of instalment premiums or premium credit were offered by around 50% of intermediaries.

Assisting with the management of captive insurance companies was the only issue on which there was a difference between smaller clients and large clients – which is to be expected given that captives are generally only used by large clients.

Regulatory status of intermediaries and searching the market

Under the Insurance Mediation Directive, intermediaries need to disclose the basis on which their advice is given. In particular, they need to disclose whether their advice is given on the basis of:

- A fair analysis in which case the intermediary is obliged to give that advice on the basis of an analysis of a sufficiently large number of insurance contracts available on the market, to enable him to make a recommendation regarding which insurance contract would be adequate to meet the customer's needs; or

- A contractual obligation to conduct business exclusively with one or more insurance undertaking in which case, at the customer's request, the intermediary shall provide the names of the companies; or

- The intermediary is not under a contractual obligation to conduct business exclusively with one or more insurance undertakings but does not give advice based on a fair analysis.[32]

According to results gathered through the trade association survey, in the SME segment, around 60% of intermediaries stated that they operated on a fair analysis basis and 37% advise on the basis of a limited number of insurance undertakings. In the large client segment, around 80% of intermediaries stated that they operated on a fair analysis basis. It is also notable that in their response to the survey, individual intermediaries stated that they operated on a different basis for different types of products. This may reflect the use of panels or binding authorities (see section 3.4.3) in different lines of business.

The process of searching the market varies:

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31 The survey did not separate out the function of searching the market. The Trade Association survey did not distinguish between SMEs and businesses that would be categorised as micro-enterprises in this report and where reference is made to the Trade Association survey, the SME category should therefore be seen as combining these two categories.

32 Directive 2002/92/EC of the European Parliament and of the Council of 9 December 2002 on insurance mediation.

- In the Lloyd’s market, where business is written on a subscription basis, with more than one syndicate participating on the same risk, the initial focus is on choosing the lead underwriter with whom terms are agreed. The intermediary will then find other syndicates who will accept the remaining parts of the risk (on the same terms as those agreed with lead underwriter). The lead underwriter’s reputation is therefore important to getting additional companies to fill the slip; and[33]

- In the company market the entire risk is often placed with one insurer. In this case, rival companies will bid to provide cover for the same risk, although in some cases with more complex or large risks there may be co-insurance of a risk, or different companies will insure different layers of the same risk.

The amount of search undertaken will depend on a number of factors including:

- the specialist nature of the insurance to be obtained since there may only be a relatively small number of insurers with expertise to provide the insurance;

- the insurance cycle and the difficulty in getting coverage which may encourage the intermediary to advise staying with the existing insurer; and

- the sophistication and demands of the client.

For many large risks it is typical for there to be an iterative process involving identifying the insurers that would offer a quote and then reducing the number of insurers down to those who appear to be offering the best quote. Then there may be a process of refining the details of the cover and quote which would include discussions of both gross premium and any commission payments.

Where panels or binding authorities are in place, the search process arises in a different manner with search arising at the stage of constructing the panel or binding authority. Then when clients meet the characteristics such that the policies available through a panel or binding authority are appropriate, these would be chosen. CRA has not examined the method by which intermediaries select panels or binding authorities.

3.4.2. Services provided by the intermediary to the insurer

As well as providing services for clients, intermediaries may also undertake part of the work that might usually be considered to be part of the underwriting function. This is commonly known as “work transfer”. Services that could be outsourced would include issuing of policy documents (typically issued by the Lloyd’s broker in the Lloyd’s market); and claims handling from the insurer’s side.

33 Although the role of the lead underwriter is specific to the Lloyd’s market, intermediaries did not always distinguish between insurers in the companies market and the Lloyd’s market. Indeed, the same insurer can participate in both the companies market and the Lloyd’s market e.g. Hiscox.

In some cases the intermediary will also decide some of the terms on which insurance will be offered. In these cases the insurer is effectively simply there as a provider of capital. This is also closely linked to the provision of binding authorities which is considered below.

One of the complexities of work transfer arrangements is that intermediaries will require remuneration for undertaking this work and therefore it may be unclear whether remuneration paid by the insurer to the intermediary is to reflect work done on behalf of the client or the insurer.

3.4.3. Binding authorities

Binding authorities are agreements where the intermediary is given the right to enter into contracts of insurance on behalf of the insurer. In the case of the Lloyd's market, the intermediary would be known as a "coverholder". The agreement would set out the scope of the delegated authority that the intermediary or coverholder would have. This could vary from:

- the intermediary simply having the right to agree the contract (i.e. "bind" the parties) but being required to check all of the details of the cover, price and whether or not the insurer will actually take on this particular risk with the insurer – a "limited binding authority"; or

- the intermediary could have the authority to agree terms with the client including the price and whether to accept the client's risk – a "full binding authority". This would be subject to certain prescribed limitations regarding the sorts of risks that insurers would be willing to accept.

There is a spectrum of authority that is delegated to intermediaries and those with less experience will get a narrower authority. It is also common for the binding authority to vary depending on the size of the risk. Those with binding authorities would also typically issue policies, collect premiums and undertake the credit control.

Binding authorities are used because intermediaries may be in a better position than underwriters to undertake certain activities at lower cost. Both insurers and intermediaries stated that specialist intermediaries are better placed to identify business that can be written through binding authorities. This can also make it profitable to attract smaller premium business than would be the case in the absence of these arrangements. Furthermore, intermediaries and insurers agreed that one of the advantages is the speed of granting cover since the intermediary can bind the parties without reverting to the insurer.

Evidence from the Trade Association survey found that of the 38 intermediaries who responded, 27 of them had at least one binding authority in place although no intermediary had a binding authority in all lines of business. Among those with binding authorities the average number of binding authorities was 14 although one intermediary had 70. Many intermediaries had more than one binding authority for a particular type of insurance (e.g. on average those with binding authorities had 8 for liability insurance).

However, this is likely to reflect different types of liability insurance rather than having multiple binding authorities for exactly the same type of risk.

Table 4: Binding authorities

	Number with a binding authority	Average number of binding authorities among those with binding authorities	Maximum number of binding authorities
Accident and Health	12	4	19
Marine / Aviation / Transport	12	3	13
Property	18	6	23
Motor	8	3	9
Pecuniary	4	1	2
Liability	17	8	37
Other	5	3	4
All / any	**27**	**14**	**70**

Source: Trade Association Survey. Note that the figures are based on a survey of 38 intermediaries.

Evidence from both interviews and the compliance survey found that the importance of binding authorities varied significantly between both intermediaries and insurers. In the case of intermediaries, the proportion of gross written premium written under binding authorities varied between 0% and almost 100% for certain intermediaries. They appear to be most common for Lloyd's intermediaries where they average around 20% of business through our sample and large regional intermediaries where they averaged around 12%. Large insurers were found to have around 15% of business through binding authorities.

Since binding authorities involve intermediaries taking actions on behalf of insurers, remuneration, especially profit commission, is often used to align the incentives between the intermediary and the insurer. In addition, it is important for insurers to monitor the use of binding authorities and so they are audited, reviewed and a "bordereau" needs to be completed. A bordereau is a detailed report of insurance premiums or losses containing a list of policies insured during the reporting period. This contains such information as the name and address of the insured, the amount and location of the risk, the effective and termination dates of the primary insurance, and claims outstanding and paid.

Connected to binding authorities are Managing General Agents (MGAs) which are where firms are authorised by an insurer to transact insurance business on their behalf. This may include having authority to bind the insurer, issue policies, adjust claims and provide administrative support. MGAs are becoming increasingly popular as part of a trend of "vertical integration" by intermediaries expanding into underwriting small business risks.

There is considerable confusion in the market regarding the status of MGA arrangements and the implications for them regarding the current requirements for commission disclosure. The FSA has stated that, since MGAs are not themselves insurance companies, they would be treated as intermediaries and therefore would currently need to disclose remuneration arrangements on request.

In summary, it is common for intermediaries to act under a binding authority or as an MGA. This reduces transaction costs but may necessitate particular types of remuneration to align incentives.

3.4.4. The role of intermediary chains

As indicated in Figure 1 in section 3.2, there are a number of different routes to market that may arise for domestic UK business. One of these routes is for the client to approach an intermediary who directly accesses the insurer. However, an alternative approach is for the client or primary intermediary to approach a specialist or wholesale intermediary instead of directly accessing the insurer. There are four main occasions where this may arise:

- Where the primary intermediary is not a Lloyd's broker and requires access to the Lloyd's market;
- Where the primary intermediary recognises that they do not have the specialist knowledge regarding a category of risk;
- Where the wholesale intermediary has a binding authority or a "facility" to offer a particular form of insurance that the primary intermediary may not be able to access directly; and
- Where international business is being written in the UK.

Evidence from interviews suggests that the use of chains in the UK is not uncommon especially for business that flows to the Lloyd's market. However, the chains are relatively short typically involving one or two wholesale intermediaries (although one may be acting as a cover holder) in addition to the primary intermediary.

Generally, the primary intermediary will not use an additional intermediary if this can be avoided since this reduces the revenue that they receive as commission must be split with other intermediaries in the chain. This provides a restraint on the creation of inefficient chains.

There has also been a trend towards vertical integration by some intermediaries who have incorporated Lloyd's brokers into their organisation. In addition, some insurers are seeking to reduce the length of chains by identifying primary intermediaries to whom they can offer binding authorities rather than using wholesale intermediaries. By contrast, some wholesale intermediaries interviewed made it clear that they did not wish to become primary intermediaries as they would need to change their business model if they were to deal directly with clients.

Access to the Lloyd's market

As noted in section 3.3.1, only Lloyd's brokers may access the Lloyd's market. There are only 167 accredited Lloyd's brokers whereas there are several thousand authorised intermediaries who may need to access the Lloyd's market at least on occasion if not more frequently.

Intermediaries could seek Lloyd's accreditation in order to become an authorised Lloyd's intermediary. However, interviews with medium sized regional intermediaries (gross written premiums of around £30-50 million) have indicated that many of these firms do not wish to incur the costs of setting up a team of intermediaries in London and meeting the standards set by Lloyd's.

Lack of specialist knowledge

In some cases, the primary intermediary will not have sufficient knowledge about a particular risk to know where to access the necessary insurance for their client. In these circumstances, the primary intermediary may approach a wholesale intermediary who does have the necessary expertise in this market.

Access to specialised insurance

Closely linked to a lack of specialist knowledge is the situation where a wholesale intermediary may have access to a particular insurance product that other intermediaries may not be able to offer. In some cases this is simply because the fixed cost of dealing with intermediaries means that insurers may not be willing to deal with small firms. Thus small intermediary firms may therefore need to use a wholesale intermediary instead.

In other cases, wholesale intermediaries are "making markets" and approach the underwriter to agree particular terms and conditions for an insurance product. The wholesale intermediary can provide sufficient customers to make this a worthwhile investment for the insurer, and in return the intermediary may gain exclusivity over the product. Other intermediaries would not be able to gain access to this product without using the wholesale intermediary who has this particular facility available.

In each of these three cases there may be natural constraints imposed on the length of chains because of a desire to control the risks that insurers are exposed to. Interviews with both insurers and wholesale intermediaries indicated that there is often a requirement that the intermediary bringing the business to the wholesale intermediary that holds the binding authority must be the primary intermediary. This is because of control reasons, a reluctance of insurers to deal with certain intermediaries and client money regulations which become unmanageable in a long chain.

International chains

For international business that is accessing the Lloyd's market from overseas, the use of chains is usual. In particular, it is common for there to be more intermediaries in the chain than might be the case in the UK. Business from the US, for example, might originate with a primary intermediary who would seek the assistance of a larger wholesale intermediary in the US, who would then seek the assistance of a UK based Lloyd's intermediary to place the client's business at Lloyd's. In Latin America it is common to have very long chains. Many wholesale intermediaries with international business will also be making markets by identifying primary intermediaries and arranging facilities with underwriters at Lloyd's.

3.4.5. London and the regional market

As well as the distinction between the Lloyd's market and the company market in respect of insurers, a distinction is typically made in the intermediary market between the "London market" and the "regional market".

The London market refers to the business done either through Lloyd's or the company market that typically relates to the large and specialist risks for which Lloyd's (of London) is particularly associated. The regional market is used as a term to distinguish business from the London market – broadly it could be thought of as the market that deals with smaller, somewhat more homogeneous domestic risks. Although the names suggest that the distinction is in respect of the location of clients (whether they are geographically located in London or outside London) in fact the distinction relates more to the types of clients or risks rather than their location. For example, a small client with relatively simple risks that is geographically located in London would nonetheless be considered by intermediaries to be part of the regional market.

As with the distinction between the Lloyd's market and the company market, the use of the term "market" should not be taken as evidence that these are two separate economic markets. Indeed, risks that come in through regional intermediaries may end up being insured through the London market.

Nonetheless, insurers and intermediaries believe competition varies significantly between the London market and the regional market. In part this distinction is made because the market share of the top four intermediaries (Aon, JLT, Marsh and Willis) varies according to the size of the client.

Consolidation

Within the regional market, one of the clear trends in the past five years has been the considerable degree of consolidation that has occurred in the regions. As at March 2007, the FSA indicated that there were 8,253 regulated firms including 28 non-UK intermediaries passporting into the UK. According to previous annual reports this has fallen from 10,833 authorised general insurance intermediary firms on the 31st March 2005 and 9,473 authorised general insurance intermediary firms on 31st March 2006.[34]

[34] FSA Annual Report 2006/07. However, it is important to note that this does not include the number of appointed representatives. It is therefore difficult to make meaningful comparisons over time.

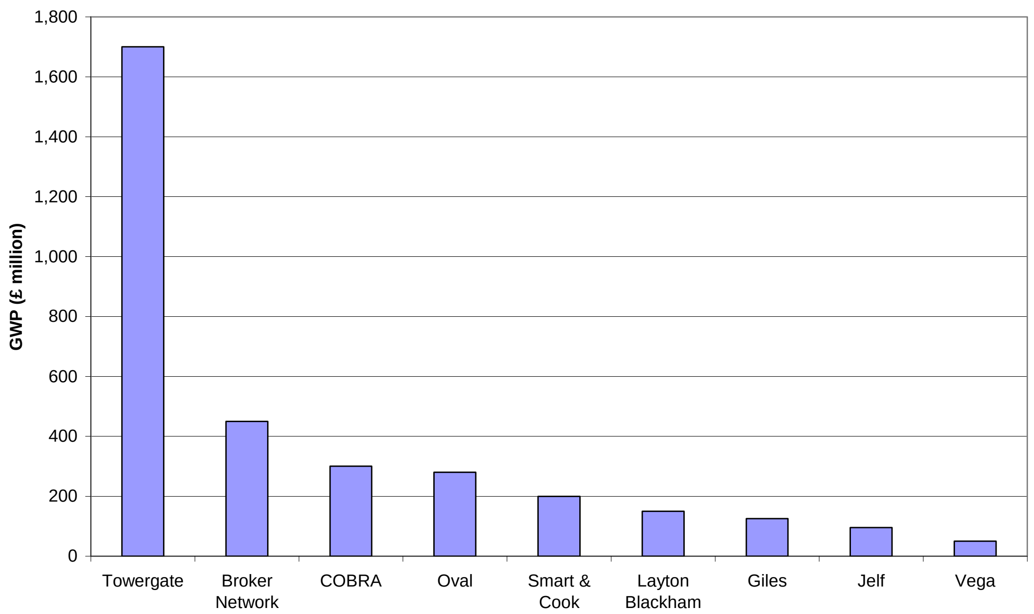
Some larger firms have become known as "consolidators" because they have bought the business of many smaller intermediaries.[35] This is seen as a way of quickly growing an intermediary business. In a market where switching rates are less than 10% (see section 4.3), growing organically could be especially challenging as the number of clients that it would be possible to attract through switching will be low.

Interviews with insurers and intermediaries indicated that as the consolidating firms have increased in size, they have been able to use their bargaining power to obtain higher commission payments from insurers. In turn part of these higher payments of commission are understood to be funding the increased purchasing of additional intermediaries leading to yet further consolidation. There is no evidence that the increased bargaining power of these intermediaries is leading to lower prices for their clients (although no evidence of increased prices either).

Finally, as the consolidators have grown, some of them have moved to vertically integrate by offering insurance products through an MGA or by purchasing a Lloyd's intermediary.

Figure 5 below provides details on some of the larger consolidators and it is clear from the chart, that Towergate is by far the leader of this part of the market.

Figure 5: Leading consolidators



Source: UK Commercial General Insurance 2006, Datamonitor[36]

35 UK Commercial Insurance Distribution 2006, Datamonitor

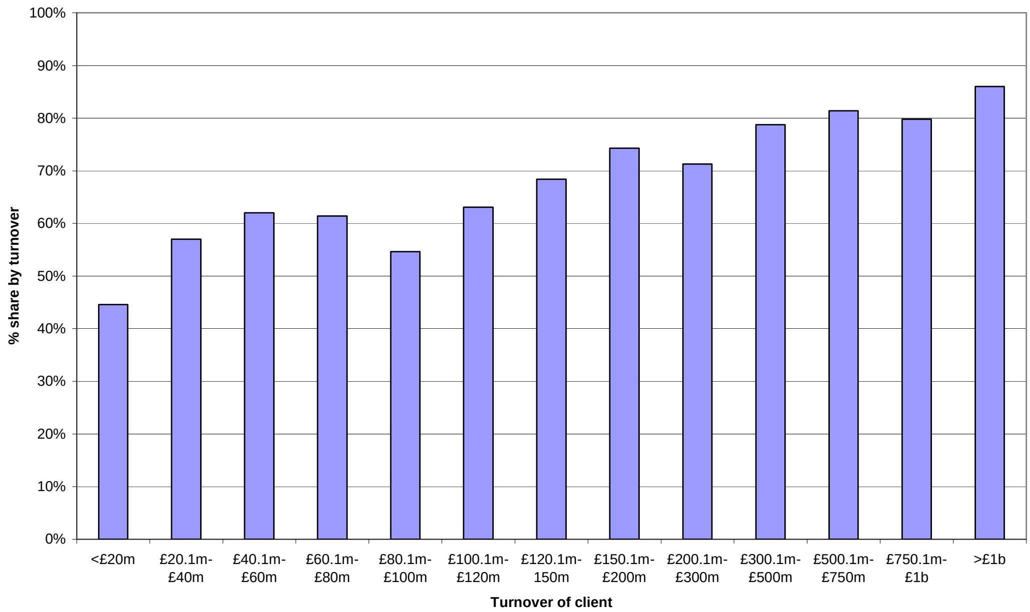
36 Since publication of the Datamonitor report, Layton Blackham and Smart & Cook have both been purchased by Axa (along with Stuart Alexander). Axa press release 23rd April 2007.

3.4.6. Competition in the intermediary market

Market concentration

Concentration in the intermediary market varies considerably according to the size of the client as shown in Figure 6 below.

Figure 6: Market share of international intermediaries by client turnover



Source: CRA analysis of UK Commercial Insurance Distribution 2006, Datamonitor. The international intermediaries are categorised by Datamonitor as Aon, JLT, Marsh and Willis.

The top four intermediaries have a larger market share among larger clients which reflects the more complex risks that these clients are likely to face and thus the requirements to use intermediaries that are likely to be able to have the expertise necessary to deal with these risks. However, even among clients with an annual turnover of less than £20 million, the top four have a market share of around 45% (in terms of GWP).

Despite this concentration by client turnover, there is in fact a long tail of much smaller intermediaries in the general insurance sector.

Datamonitor figures are calculated on the basis of the turnover of the client and find that overall the market share of the top three intermediaries is 76%. However, information from the ABI (focused on the company market) finds that the "national brokers" have a market share of 50%.[37]

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37 ABI General Insurance Statistics. Figures relate to 2005.

Given the discussion in the previous section, it would be expected that the international intermediaries would have a higher market share in the Lloyd's market than in the company market. We estimate the market share of the large international intermediaries at between 50% and 60% of the market.

Substitutes for intermediation

Instead of using an intermediary to obtain insurance, some small clients choose to purchase this insurance direct from the insurer. Most of the large insurance companies have a direct offering to small companies which they state has both grown in recent years and is also expected to continue to grow in the future. In part the development of low cost distribution via the internet and low cost automated underwriting is behind this trend as well as changing behaviour from clients who are increasingly willing to use internet distribution methods for accessing commercial insurance policies because they use similar distribution methods for their personal insurance needs.

According to ABI statistics, the direct channel represented around 8% of commercial general insurance premiums in 2005.[38] Evidence gathered during interviews suggested that this had increased to around 11% in 2007. Within the micro-enterprise and SME channel, some insurers operating in this market believed that there was scope for this to increase to as high as 20-25% of the market over the next few years.

In response to this trend, interview evidence indicated that some intermediaries have already chosen to withdraw from serving small clients as these clients become increasingly price driven and the direct channel forms a viable alternative. It was expected that this withdrawal of intermediaries would continue to occur in this part of the market.

3.5. INTERMEDIARY REMUNERATION

This section of the report explains the levels and types of intermediary remuneration that are typical in the UK commercial general insurance market. The structure of remuneration varies significantly depending on the part of the market being served. Intermediaries may be compensated via:

- Commission paid by the insurer;
- Fees paid by the client, usually in lieu of commission;
- Contingent payments from an insurer based on the volume or profitability of the business placed by the intermediary;
- Payment for facilitating premium finance; and

38 General Insurance Business Statistics, ABI.

- Work transfer (payments by an insurer for work performed by the intermediary on behalf of the insurer).

The structure of remuneration varies sharply by type of customer and this has a strong bearing on transparency and the potential need for disclosure. In general, large sophisticated companies will seek to remunerate their intermediaries with fees. Sophistication in this regard is usually a function of the presence in the company of a full time risk management professional experienced in the purchase of insurance and familiar with insurance market practices. These professionals usually insist on a fully transparent fee based remuneration model for their intermediary. These large customers very often use the largest multi-national intermediaries who are therefore accustomed to fee based compensation from such clients.

The intermediary remuneration model for smaller clients is usually not fee based. Intermediaries dealing with these clients will typically be paid commission by the insurer, and may also receive contingent payments from the insurer. Commission is paid as a percentage of premiums from the insurance contract, while contingent payments are determined by the volume or profitability of the intermediary's book of business with an insurer. Intermediaries claim that, for smaller customers, commission is a more logical form of compensation as negotiation of a fee would be too burdensome given the small amount of business involved.

The amount of compensation from either standard commission or contingent commission is not known to customers unless disclosed by the intermediary. Under the current disclosure regime, the customer is entitled to demand disclosure, and the intermediary is obliged to give it. Intermediaries state, however, that there are very few such requests currently, and the evidence we have gathered from market participants and customers supports their view. Nevertheless, a number of intermediaries disclose commission voluntarily (including, but not limited to: Aon; Marsh; and Willis as a result of their Spitzer settlement). However, according to interview evidence, contingent payments are not typically disclosed in cash terms even when intermediaries disclose standard commission.

The regional market tends to be made up of micro-enterprises and SME clients, and they are served by regional intermediaries who usually base their remuneration on the commission model. Nevertheless, the national intermediaries still have very significant market share in these regional markets where they, too, will operate a commission based model.

As discussed in the last chapter, this intermediary remuneration model with smaller customers may introduce certain kinds of bias into the behaviour of the intermediary. Non-disclosure means that such biases, if they exist, cannot be checked directly by the customer, nor does the customer have the opportunity to question the level of compensation of the intermediary. We will return to this topic after reviewing our customer research in the next chapter.

Work transfer payments are another form of intermediary remuneration which are present across the market. This relates to activities performed by an intermediary on behalf of an insurer, such as claims management or underwriting. Work transfer is usually expressed as a percentage of premiums and paid to the intermediary in this form. Because MGAs often perform the underwriting function for an insurer, and issue policy documents on behalf of the insurer, there is usually a work transfer payment in the MGAs compensation model from the insurer.

3.5.1. Fees and commission

Large clients will typically pay for intermediation services through the use of fees rather than commission.

The use of fees also varies by intermediary and the international intermediaries are more likely to have clients who pay on a fee basis compared to other intermediaries. With the exception of these intermediaries, there appears to be little relationship between the size of intermediaries and the proportion of business conducted with fees. Based on FSA data collected through the Retail Mediation Activities Return (RMAR) we find that on average 10% of intermediary remuneration is through fees, although evidence from the European Commission suggests that fees could represent around 20% of intermediary remuneration.[39]

It is possible that even when an intermediary is being paid fees, they may also receive commission from the insurer.

3.5.2. Commission levels

Commission rates are set out as part of the agency agreement between the insurer and intermediary and in the regional market are typically negotiated once a year (although in the London market it may be more frequent than this). The outcome of this negotiation will be dependant on the relative bargaining power between the intermediary and insurer, and the underwriting cycle.

Evidence from the ABI on the level of commission and expenses as a share of net commercial premiums written by ABI members finds that there is considerable variation in this by category of insurance which varies from 20% for motor insurance to 47% for pecuniary loss insurance.[40] This may reflect motor insurance having more homogenous risks than other categories of insurance.

Evidence from the Trade Association survey also identified variation by categories of insurance as well as a very wide range of levels of commission being earned by different intermediaries on business for SME clients.

39 Sector Inquiry under Article 17 of Regulation (EC) No 1/2003 on business insurance (Final Report), European Commission, September 2007.

40 Source: ABI General Insurance Statistics. Other categories included: aviation (21%); employers' liability (22%); marine (27%); property (37%); and transport (37%) These percentages therefore represent an upper bound on the level of commission.

Table 5: Average commission rates

	Minimum for SME clients	Maximum for SME clients	Average for SME clients	Average for large clients
Accident and Health	3%	30%	19%	17%
Pecuniary	5%	51%	19%	16%
Marine / Aviation / Transport	7%	30%	18%	14%
Other	5%	28%	17%	15%
Property	4%	28%	17%	14%
Liability	5%	27%	15%	13%
Motor	5%	25%	12%	11%

Source: Trade Association Survey. Note that the figures are based on those who provided a response which varies by category and the average is a simple (unweighted) average.

Table 5 also shows that the average level of commission paid is around 2-3% higher on business for SME clients than for large clients which is consistent with large clients being able to extract better prices from their intermediaries.

In addition to the Trade Association Survey, data was also gathered from insurers and intermediaries who participated in the interview process. This can be found in Table 6 below.

Table 6: Reported levels of commission

	Average range of commission rates
Insurers	18-22%
Intermediaries	15-25%

Source: CRA interviews

Table 6 shows a wider range of commission rates for intermediaries than for insurers. This is likely to reflect the fact that some intermediaries have very strong bargaining power and are able to obtain higher commission than others. By contrast, insurers are likely to face a mix of intermediaries and therefore have a smaller range of rates on average. Interview evidence also identified that some intermediaries may receive substantially higher levels of commission than the figures quoted.

Overall we conclude that the level of commission averages around 20% across the whole market although there is a significant variation around this both by type of insurance and by type of intermediary. In addition, the evidence shows that larger clients pay a lower percentage of commission than smaller clients.

3.5.3. Contingent commission

Some intermediaries may receive contingent commission payments which as noted in Chapter 2 can take two forms: profit based commission; and volume based commission. As discussed earlier, both forms of payment have the potential to lead to bias in the behaviour of intermediaries.

Evidence gathered from interviews with insurers (who accounted for more than 70% of the UK commercial insurance market) found that the great majority of these insurers paid contingent commission. This is also supported by evidence from the EC which found that 75% of UK insurers pay contingent commission.[41]

On the intermediary side, the large international intermediaries (Aon, Marsh and Willis) do not accept contingent payments because of their settlement in the Spitzer investigation.

However, with the exception of these three firms, the majority of contingent arrangements are with large intermediaries. For example, a number of large insurers indicated that, of the thousands of intermediaries with whom they deal, only around 400-500 would have contingent commission arrangements.[42] They confirmed that these intermediaries would tend to be larger intermediaries who have some degree of bargaining power and with whom it was worthwhile incurring the costs of entering into contingent commission arrangements.

Of the two types of contingent commission, interviewees indicated that profit commission was more prevalent than volume commission, although it was also noted that it was not always possible to separate these arrangements since profit based arrangements may only apply if a particular volume of business is placed with the insurer.

Intermediaries responding to the FSA's Trade Association Survey reported that volume based contingent payments each represent around 3% of revenue and profit based payments were 4% of revenue for SME clients and a percentage point smaller for large clients. However, interview evidence revealed that the level of contingent payments would be strongly linked to the bargaining power of the intermediary (which could reflect their size or could reflect specialisation in a particular type of insurance). In some cases, intermediaries could potentially receive very large contingent payments.

3.5.4. Profit-based commission and binding authorities

As noted in section 2.1, insurers suffer from asymmetric information because they do not know whether a particular client is a low or high risk and the client always has the incentive to portray itself as a low risk. The intermediary, by contrast, has more information than the insurer regarding the likely risk associated with a given client.

41 Sector Inquiry under Article 17 of Regulation (EC) No 1/2003 on business insurance (Final Report), European Commission, September 2007.

42 Note that this is a much smaller proportion of intermediaries than the 75% suggested in the EC's report.

Insurers can therefore attempt to align the interests of an intermediary with its own interests by linking the level of commission paid with the profitability of the business placed and thereby encourage intermediaries to place more profitable business with them.

In turn this may allow insurers to more accurately set prices (to the benefit of low risk clients) as they may be more willing to set lower prices for those clients where the intermediary receives profit commission since this may be indicative of the clients not being high risk clients. The net result is that profit commission could make the market more efficient by improving the accuracy of the information used to price risks.

The role of profit based commission is especially important where intermediaries have binding authorities or are acting as an MGA. In these circumstances the insurer needs to be confident that the intermediary only writes good quality (i.e. profitable) business on their behalf rather than simply writing as much business as possible to maximise commission payments. Profit based commission helps to align these incentives.

In addition, profit commission provides ones of the incentives for intermediaries to "make markets" (see section 3.4.4) by identifying clients that have a particular need and approaching the underwriter to agree particular terms and conditions for an insurance product. The absence of profit commission may mean that these needs are not otherwise met.

The Trade Association Survey identifies that having a binding authority leads to an increase in commission of 4%-10% of premiums depending on the line of business.[43]

3.5.5. Market Service Agreements and work transfer

Another form of remuneration paid to intermediaries stems from Market Service Agreements (MSAs). In these agreements the insurer pays the intermediary a flat rate of commission on the entire book of business brought to the insurer during the course of the year. Typical rates are around 2.5% of total gross written premiums.

There is considerable variation regarding the observed role of MSAs. Some intermediaries have stated that this payment reflects compensation for services provided by intermediaries on behalf of insurers and as such is a reward for "work transfer" arrangements. Indeed, many insurers are using work transfer arrangements in which intermediaries agree to take on some of the underwriting functions on behalf of the insurer. Where this is the case insurers believe that intermediaries are performing a valuable role and undertaking services more efficiently than the insurer would be able to and it is reasonable to compensate the intermediaries providing these services.

43 Note that these figures are based on a small sample of insurers who provided evidence on both standard rates of commission and rates of commission with a binding authority.

Other intermediaries (including some of those applying such MSAs) and most insurers have stated that the MSA simply reflects an increase in price of existing intermediary services.

MSAs that are linked to work transfer represent compensation for a service provided as a result of a competitive negotiation between intermediaries and insurers. To the extent that this leads to efficient provision of services this does not represent a source of customer detriment. However, complexities arise when these arrangements are used as a method of increasing the payment to the intermediary and not disclosing such information to customers who require transparent disclosure.

3.5.6. Intermediary remuneration in chains

Where intermediary chains exist (i.e. there is more than one intermediary between the insurer and the client), any commission paid by the insurer must be split between the intermediaries in the chain.

There are no set rules as to how this split arises and this is a matter of commercial negotiation between the intermediaries in the chain. In some cases the primary intermediary holds the bargaining power because they have access to the client. In other cases the wholesale intermediary holds the bargaining power because it controls access to a particular market or product such as where they have a binding authority that they have specifically arranged.

It is also possible for intermediaries in the chain to have contingent arrangements with the insurer which further complicates the picture of remuneration, and which can make total compensation in the chain difficult to reconstruct. This may arise where profit commission is paid on binding authorities that may be held by a wholesale intermediary – again there are no set rules that apply regarding the split of any contingent arrangements within the chain.

Finally, current FSA disclosure rules mean that only the primary intermediary must disclose commission if asked by the client and there is no requirement for wholesale intermediaries to disclose their commission.

At present therefore, customers who ask for commission to be disclosed may receive only partial disclosure of the total intermediary remuneration paid in the chain. Furthermore, some clients may be unaware of the presence of a chain of intermediaries.

3.6. COMMISSION DISCLOSURE

As noted earlier a number of intermediaries are already disclosing commission to customers. It is therefore important to assess the prevalence of this disclosure since it affects the extent of any potential market failure resulting from a lack of transparency. Our estimate is based on the following pieces of evidence:

- Approximately 50% of clients in our survey stated that they received commission disclosure from their intermediaries (see section 4.4 for further details). The proportion receiving such information increases with the size of company.[44] In addition, evidence from interviews with large companies (not included in the client survey) finds that they would nearly always require disclosure of any commission earned (although they would typically be working on a fee basis). This suggests that disclosure as a proportion of gross premiums would be greater than 50%;

- The largest international intermediaries disclose their remuneration to their clients as a result of the Spitzer investigation. As noted earlier, the market share of the large international intermediaries is between 50% and 60% of the market. Evidence from our interviews and compliance cost survey identified additional intermediary firms that had voluntarily chosen to disclose commission automatically to their clients.

On the basis of this evidence, we estimate approximately 50-60% of the market as measured by gross written premium is currently receiving commission disclosure.

44 Taking into account the population of companies of different sizes and the propensity to be disclosed to we estimated that approximately 50% of companies by revenue are disclosed to. When considering only the middle segment (excluding micro-enterprises), the proportion who are disclosed to is greater than 50%.

4. DEMAND FOR INSURANCE AND INTERMEDIARY SERVICES

In order to understand the demand for commercial insurance and services of insurance intermediaries we have interviewed insurers and intermediaries and collected information directly from clients through:

- in-depth case study interviews with 12 companies ranging from micro-enterprises to larger multinational companies; and
- a telephone-based survey with 200 companies that have an annual turnover of less than £100 million.

Based on the interviews and analysis of the data we have used a common segmentation of clients based on turnover. As with the rest of the report we refer to:

- Micro-enterprises as companies with turnover of less than £500,000;
- Small to Medium Enterprises (SMEs) as companies with annual turnover between £500,000 and £100 million;[45] and
- Large corporate customers (LCCs) as companies with over £100 million annual turnover.

Section 4.1 presents the key findings from the whole chapter. Section 4.2 provides evidence on the demand for insurance and the use of substitutes to insurance. Section 4.3 examines information on the choice of distribution channel, the use of intermediaries and the services that they offer as well as examining the different selection criteria that clients use to choose or change their intermediary. Section 4.4 examines remuneration for intermediary services and the extent of clients' understanding of the level and different types of remuneration that intermediaries receive.

4.1. SUMMARY OF KEY FINDINGS

Based on the evidence from the client survey, the case studies and supporting market research, the main conclusions from this chapter are as follows:

1. Competition for intermediation services varies between the client segments. This is seen in the process of choosing intermediaries where large firms use a formal process of competitive tender that often includes negotiating a fee, whereas smaller companies base their choice on past experience and personal recommendations.

45 This differs from the convention adopted in the European Commission's recent interim report on the business insurance sector. They differentiated between companies with less than 250 people and whose turnover was under €50 Million. Datamonitor adopt the DTI's categories with small companies having less 50 employees and medium sized companies having 50 to 250 employees.

2. Competitive discipline on intermediation from direct channels is limited to micro-enterprises who have relatively straightforward risks. Many of these smaller clients who use intermediaries compare the quotations from their intermediary to the price of insurance through direct channels.

3. Competitive discipline on intermediation from alternatives to insurance such as self-insurance, captive insurance companies and Alternative Risk Transfer products is limited to large companies.

4. Clients have long-term relationships with their intermediaries and rarely switch to another intermediary. Evidence from the case studies, client survey and interviews with intermediaries all indicated that switching rates were less than 10% each year for all types of clients.

5. The way that intermediaries are remunerated varies significantly by size of company. Whereas large companies mainly pay fees, most SMEs pay through commission. The largest SMEs, however, pay through fees in 60% of cases.

6. Most clients are aware that they are paying standard commission but few clients are aware of other forms of commission such as contingent commission or of how much they are paying. The smallest companies are not aware of their right to ask for commission disclosure.

7. There is a clear discrepancy between what micro-enterprises and SME clients believe is a reasonable level of commission (10%) and what they are actually paying in practice (20%).

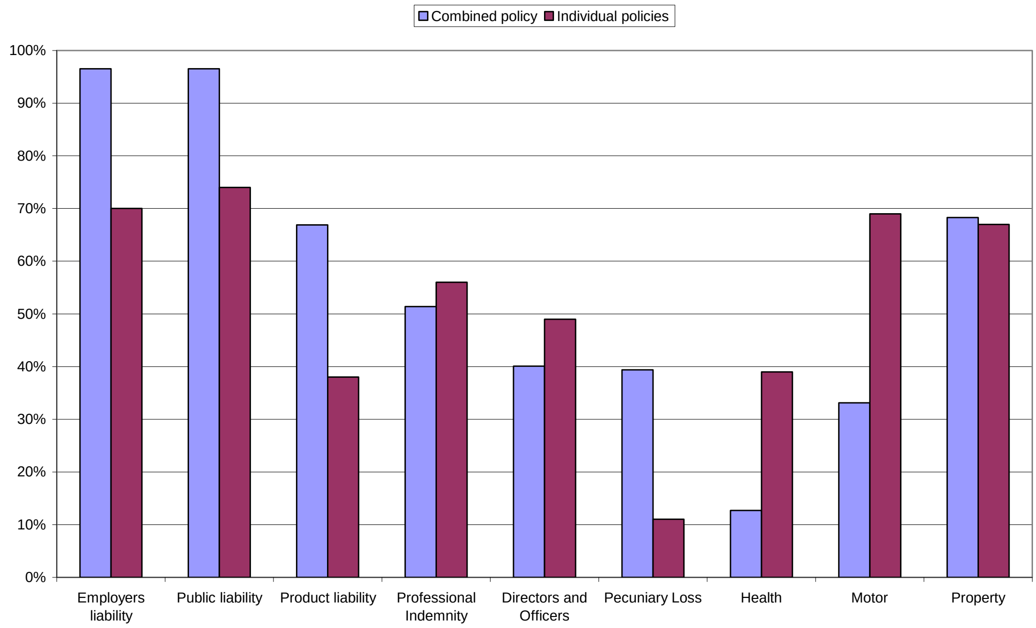
8. Overall 81% of micro-enterprise and SME clients who receive information on their intermediary's remuneration, do not use this information.

4.2. INSURANCE

There are around 4.4 million businesses in the UK, although most of these are very small with approximately 70 per cent of businesses having no employees at all.[46] All employers must purchase compulsory forms of insurance, such as employer's liability and public liability. Although companies could purchase each of their insurance policies separately, in practice the great majority of companies buy employers liability and public liability through a combined policy which also covers a range of other risks. The use of combined policies seems unrelated to the size of the company. About 30% of companies also use individual policies outside of the combined policy. This tends to cover categories such as health and motor (as shown in Figure 7 below).

46 Figure reported for 2005 from "UK Commercial Insurance distribution report 2006" Datamonitor.

Figure 7: Comparison of insurance risks covered by combined and individual policies

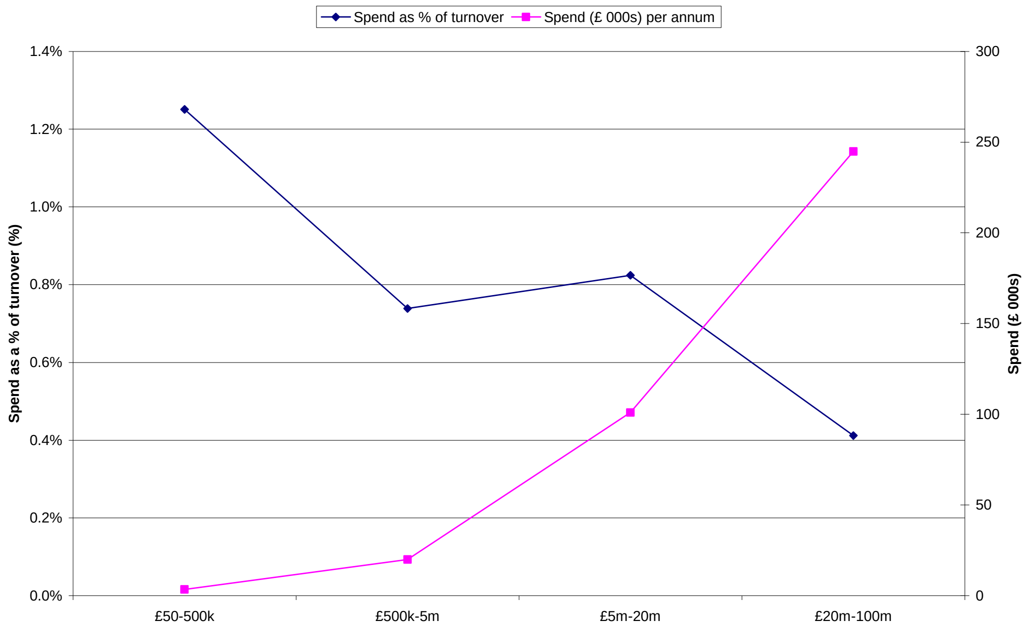


Source: CRA analysis.

The demand for different types of insurance varies by the size of company. For example, cover such as pecuniary loss was more commonly purchased by larger companies, and marine and aviation insurance were relevant only for the LCCs and were discussed during the case studies.

The type of company (manufacturing, services, distribution) is also an important determinant of the type of insurance purchased, with product liability higher for those in manufacturing, while professional indemnity is higher for companies in the services industry.

Figure 8: Spend by size of company



Source: CRA analysis.

Unsurprisingly, as firm size increases, the expenditure on insurance increases, but the percentage of turnover this represents falls (as illustrated in Figure 8).

Based on the value of expenditure on insurance by commercial clients and the number of employees of different sizes, we have estimated that size of the three different segments which is provided in Table 7 below.

Table 7: Size of different segments

	Proportion of market	Market size (GWP)
Micro enterprises (turnover less than £500,000)	17%	£3 billion
SMEs (turnover of £0.5-100 million)	52%	£9.1 billion
LCCs (turnover of more than £100 million)	31%	£5.5 billion

Source: CRA International based on CRA client survey, and DTI statistics. Note that the total does not sum to £17.7 billion due to rounding.

4.2.1. Substitutes for insurance

Competition for insurance is impacted by the availability of alternatives to taking out insurance products in the market. While these are not necessarily perfect substitutes for insurance, they pose a degree of competitive restraint on the insurance market.

There are three main alternatives that clients use instead of seeking insurance including:

- Self-insurance;
- Captive insurance; and
- Alternative Risk Transfer (ART) products.

In each case, the primary reason for using a substitute for insurance is the potential for reducing costs. Indeed, Swiss Re estimates that the non-claims portion of the premium (covering costs of acquisition, profit and overheads) can be 30-40%.[47] In addition, it enables investment income on the premiums to be retained within the group and potentially allow for more flexibility in the pattern of premiums.

It is no surprise, therefore, that most interviewees agreed that the demand for these substitutes is related to the insurance cycle. When insurance is scarce, and premiums are high, the demand for alternatives increases. Conversely, when supply is abundant and premiums fall, these alternative forms of risk transfer tend to be less popular.

Evidence from interviews with clients made clear that the use of captives and ART products was limited to LCCs. Self-insurance was also more common among LCCs although around 33% of firms in the £20m-£100m range use self-insurance to cover some risks.

Self-insurance

Rather than buying insurance, clients may choose to bear the risk themselves. This is known as self-insurance. Whether or not this should be seen as a true substitute for insurance is debatable since the client retains the risk. Yet, other things being equal, as the price of insurance increases, it would be expected that more clients would choose to bear more risk rather than pay for costly insurance.

Typically companies will only self-insure risks where losses are expected to be relatively small. Whether a particular risk is considered to be “small” will be related to the size of the company that is taking the risk. Case study interviews with clients confirmed that many large clients would be willing to self-insure some of the small risks that they faced.

In some cases, clients were willing to self-insure the whole of a particular risk. In other cases, self-insurance arises through the use of an “excess” or a “deductible” - an amount below which the client has to pay for the value of the claim. Case study interview evidence suggested that clients actively decided on the level of the excess according to the amount of risk that they were willing to bear themselves. In some companies, the use of these limits is used to incentivise different business units within the company to take actions to mitigate the risks of claims.

47 “The picture of ART”, Swiss Re, Sigma No 1/2003.

There are, however, notable exceptions to self-insurance being used only for small claims. BP provides an example of a very large multinational company that retains some very large risks.[48] This is because, given the size and specialised nature of some of BP's risks, the potential losses from highly specialised exposures may exceed the capacity of the insurance market in that area and hence BP may be in a better position than the insurance industry to bear any consequent losses.[49]

Captive insurance

Rather than bear the risk on their own balance sheets - some companies will establish captive insurance companies. These are separate companies specifically designed to underwrite risks for its parent company (or wider group). As such, they are not unlike self-insurance and are commonly limited to small value, high frequency risks.

Even when a firm chooses to set-up a captive insurance company - they may still remain dependent on the established commercial insurance industry in other ways. For example, intermediaries may assist in the administration and management of the captive insurance company.

Alternative Risk Transfer

Alternative Risk Transfer (ART) products provide companies with a means to gain compensation in the event of a loss. They therefore attempt to mirror the characteristics of insurance products which also provide compensation in the event of loss.[50]

ART products are typically used for complex risks or risks where insurance is not widely available and the products themselves are also complex.

During the case studies with large companies, ART products were not widely identified as a substitute for insurance suggesting that the use of these products is limited to very large companies. For this reason we do not include further details about these products in this report.

4.3. CHOICE OF CHANNEL AND THE NEED FOR AN INTERMEDIARY

Evidence from the client survey finds that there is a clear difference between the smallest enterprises who only require the most basic level of insurance cover via the direct channel and the rest of the market that sees the need for bespoke assistance from an intermediary.

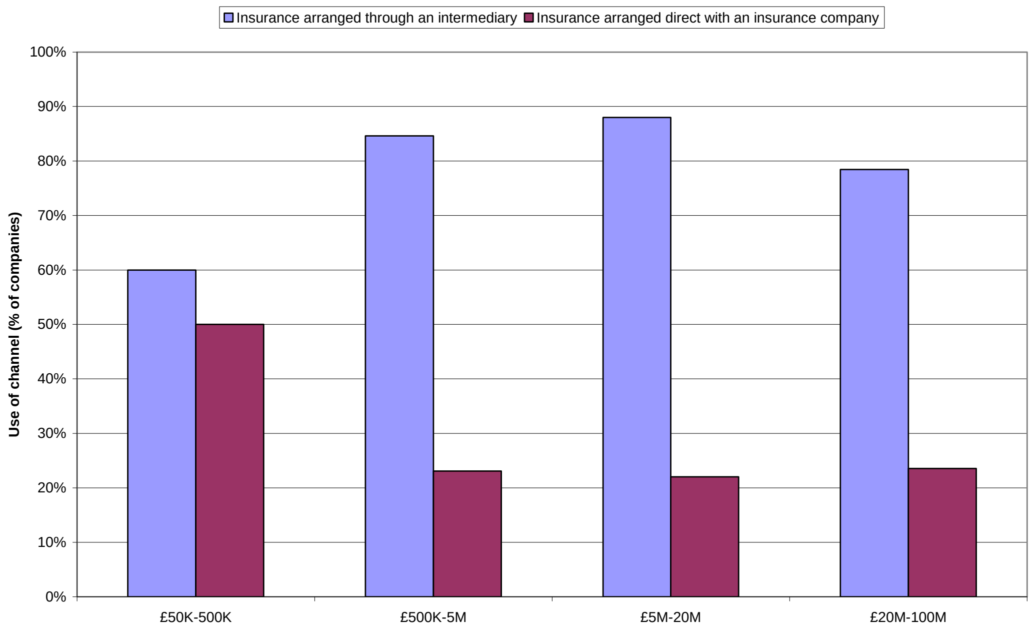
48 Information in this paragraph is taken from “Corporate Insurance Strategy: The Case of British Petroleum”, Journal of Applied Corporate Finance, Fall 1993, Volume 6.3, Doherty and Smith.

49 BP’s decision to self insure may also be affected by the very high tax rates that apply to income from oil and gas production which has the effect of reducing the true cost of any loss. Furthermore, a very large loss damaging BP’s production could lead to an increase in the oil price which further insulates BP against the loss.

50 “The picture of ART”, Swiss Re, Sigma No 1/2003.

4.3.1. Use of intermediaries

Figure 9: Use of channel by size of client



Source: CRA analysis.

As is illustrated by Figure 9, the smallest companies are the most likely to buy direct. This reflects the price sensitivity of these customers (which is the primary driver for using the direct channel). It also reflects the fact that the products they are purchasing are sufficiently homogenous to require little tailoring to the particular company's characteristics. Many of these policies may be mixed-use products covering both their personal and professional needs and the individuals may be accustomed to purchasing their personal insurance direct from insurers.

While it is clear that most SMEs and all large companies use intermediaries, this does not mean that they only use intermediaries. A number of large companies choose to use both intermediary and direct channels. Where such companies chose not to use an intermediary, this tended to focus on types of insurance that are seen as straightforward such as for motor and travel insurance, although other companies prefer to use one intermediary to arrange all risks.[51] Overall we found the use of multiple channels to be rare with only 15 companies out of our sample of 203 both approaching companies direct and using an intermediary.

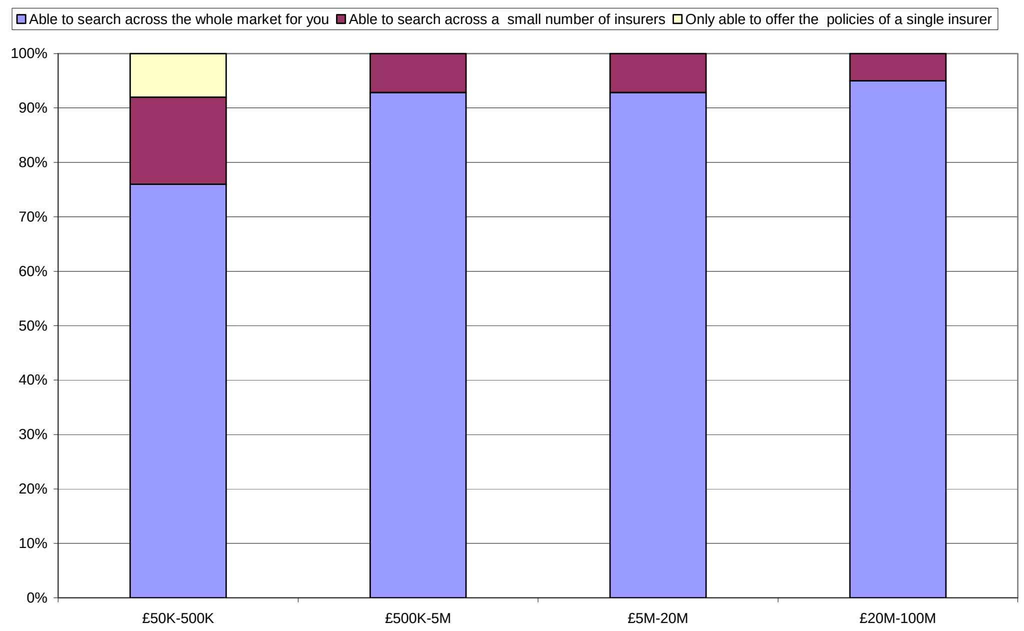
51 Based on case study interviews. This is also supported by "UK Commercial Insurance distribution report 2006" Datamonitor.

Furthermore, when asked who they would approach if they were to switch provider, most SMEs say that they would approach another intermediary rather than approach an insurance company directly.[52]

Together this evidence suggests that the direct channel is likely to only be a realistic substitute for small companies or straightforward risks, but that intermediaries are more likely to be required for larger companies.

4.3.2. Types of intermediary

Figure 10: Type of intermediary



Source: CRA analysis.

We find that the smallest companies use different types of intermediaries with 10% of these companies stating that they use an intermediary that only offers policies from a single insurer. For all company sizes, the vast majority of clients believe that they are using an intermediary who can search the whole market.[53]

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52 "UK Commercial Insurance distribution report 2006" Datamonitor. Only 17% would consider approaching the insurance company directly.

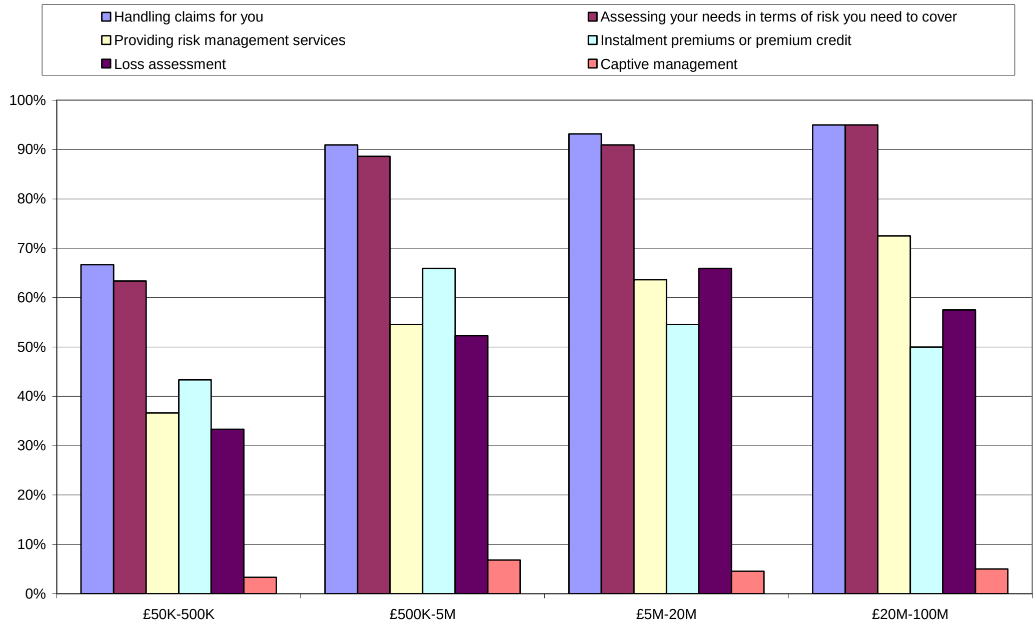
53 This is important in the light of information from the supply side suggesting that only 60% of intermediaries conduct business on a "fair analysis" basis and 37% use a limited number of intermediaries. We have not investigated this issue any further as it is outside the scope of our analysis. Additional investigation may be required to assess whether there is a market failure associated to information asymmetries regarding the scope of the search function that intermediaries are undertaking on behalf of their clients.

As shown in Figure 6 in section 3.4.5 larger companies are also more likely to use one of the large multi-national intermediaries. Discussions with both companies and intermediaries indicate that this is because the international intermediaries can offer them the range of expertise to cover all of their needs, which could include providing access to specialist risks, internal experts and international coverage.

4.3.3. Services provided by intermediaries

There are a number of reasons that companies give for using an intermediary, but interview evidence finds that the use of intermediaries is primarily due to the belief that intermediaries are best placed to search the market (as they are constantly interacting with insurers and hence know who is offering the best terms), understand policy wording, which can change from year to year, and undertake the negotiation on behalf of their client.

Figure 11: Services provided by the intermediary by client size



Source: CRA analysis

As seen in Figure 11, larger companies are more likely to use a wider range of intermediary services than smaller companies. In particular, larger companies will use intermediaries to advise on the insurance that the client needs and provide assistance in claims handling.

4.3.4. Intermediary selection and retention

This section examines how different types of commercial clients choose their intermediary and the frequency with which they review this decision and switch to an alternative supplier.

Selection criteria

The selection criteria used to appoint an intermediary is similar across companies of different sizes. The ranking of criteria from most important to least was:

- the quality of advice offered;
- total cost of the insurance (gross premium);
- the range of services offered;
- the level of fees or commission the intermediary earns; and,
- access to the Lloyd's market.

Survey evidence found only small differences by company size in the importance of these different characteristics.

Selection of intermediaries by small and medium companies

Compared to larger companies, smaller companies:

- seemingly put less weight on total cost (Gross Written Premium) – reflecting the smaller absolute value of the insurance premium to them;
- were more likely to rely on recommendations (such as from the Federation of Small Businesses or other similar companies); and
- were less likely to be concerned about access to Lloyd's.

Once the small company has established a relationship with an intermediary, there does not appear a systemised approach to reviewing the role of the intermediary, rather they are only likely to change intermediary in the event that the intermediary performs poorly.

Large corporate clients

Larger companies generally plan to review the arrangement with their intermediary every 3-4 years by setting up a commercial tender process. In the state sector, this is a requirement due to public procurement rules; in the private sector interviews suggested that it would be common to have company-wide guidelines regarding the frequency of review of all types of supplier contracts and that contracts with intermediaries would be no different.

Case study interviews with insureds made it clear that while contracts with intermediaries would be formally reviewed periodically, the experience with the incumbent would be a key determining factor in whether or not they are re-appointed. In many of the examples where interviewees had changed their intermediary, this was due to dissatisfaction with the previous intermediary.

One of the case studies illustrated the importance of personal relationships. When a team of individual intermediaries left one firm to join another firm, the client subsequently switched its relationship to the new firm in order to maintain personal relationships with the individuals.

There are two barriers to undertaking an intermediary review too frequently:

- The review disrupts the relationship with the intermediary with the result that the client would be concerned about the quality of service; and

- The selection process is seen as time consuming and expensive both for the client and for the intermediary.

The time taken to conduct reviews would often lead clients to quickly identify a short list of intermediaries from whom they would consider taking on services. Many of the larger clients would be in contact with a range of intermediaries at any one time, even if not actively using them to place business, so they are aware of the services the company could offer in the future.[54] Using a short list was seen to be of benefit to both clients and intermediaries, since intermediaries would actively participate in only those tenders where there was a reasonable chance of success. Although experience and service were the most important elements regarding the selection of the intermediary, remuneration was an important significant issue.

Furthermore, large clients are able to identify the different services that intermediaries are providing and have the option to use different firms to undertake some of these services as necessary. For example, some LCCs may use a third party to undertake claims management. Some LCCs will also use multiple intermediaries, often having one intermediary for the majority of their insurance needs and a second intermediary for particularly specialist risks.

Using more than one intermediary to obtain quotes for a particular piece of business could enable a check on the quality of the services offered by the incumbent. In practice this does not happen frequently especially for specialised risks because all of the intermediaries would be seeking quotes from the same underwriters.

Switching rates

Evidence from the case studies, client survey and interviews with intermediaries all indicated that switching rates were less than 10% each year for all types of clients. We find that SMEs are less loyal to their provider than larger companies although very small companies have a lower level of switching.[55] Our results are broadly consistent with those found by Datamonitor which are also provided in Table 8 below.

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54 Based on case study interviews.

55 The great majority of companies in the £500k-£5m turnover category in our sample have been in existence for longer than 5 years, hence higher levels of switching among smaller companies is not due to these companies only just being incorporated.

Table 8: Comparison of retention rates by size of company

	Datamonitor	CRA/Continental Research
£50-£500,000		6.7%
£500,000-£5 million	7.5%	9.1%
£5 million - £20 million		9.1%
£20 million – £100 million	4.2%	7.5%
£100 million - £1 billion	2.5%	
Greater than £1 billion	3%	

Source: CRA International & "UK Commercial Insurance distribution report 2006" Datamonitor

These levels of switching are broadly comparable to those seen for retail insurance products such as car insurance and home insurance. They are markedly less than for utilities such as electricity or gas supply, but generally higher than for personal pensions or personal banking.[56]

Even where companies are switching this may take place between a relatively small number of competitors. Datamonitor find that the largest proportion of switchers moved from one international intermediary to another international intermediary.[57]

We find that very few companies are considering switching their intermediary in the future although this increases with the size of the company. For example, around 15% of companies with a turnover of £20-£100 million are considering changing intermediary in the next year.[58] There is no evidence that the rate of switching has changed subsequent to the Spitzer investigations or as part of an ongoing trend. There is some evidence that the percentage of companies switching fell from 2005 to 2006, however, this is thought, to reflect softer markets prompting less clients to consider alternative arrangements.[59]

Although examination of switching rates is useful, it is difficult to draw definite conclusions from these rates. For example, if customers use comparisons of quotes to re-negotiate terms, then low levels of switching could still be consistent with highly contestable markets and intense competition. If there are high costs of switching it is rational for

56 Source: How to evaluate alternative proposals for personal accounts pensions, Oxera.

57 "UK Commercial Insurance distribution report 2006" Datamonitor

58 This is again consistent with "UK Commercial Insurance distribution report 2006" which focuses on large companies.

59 It should be noted that price-based switching is more common in hard markets, when premiums are increasing. In soft markets when premiums are falling, SMEs are more likely to stay with their current provider, as they will have less motivation to spend the time chasing a cheaper quote if their renewal quote is already less than, or level with, the quote they received last year.

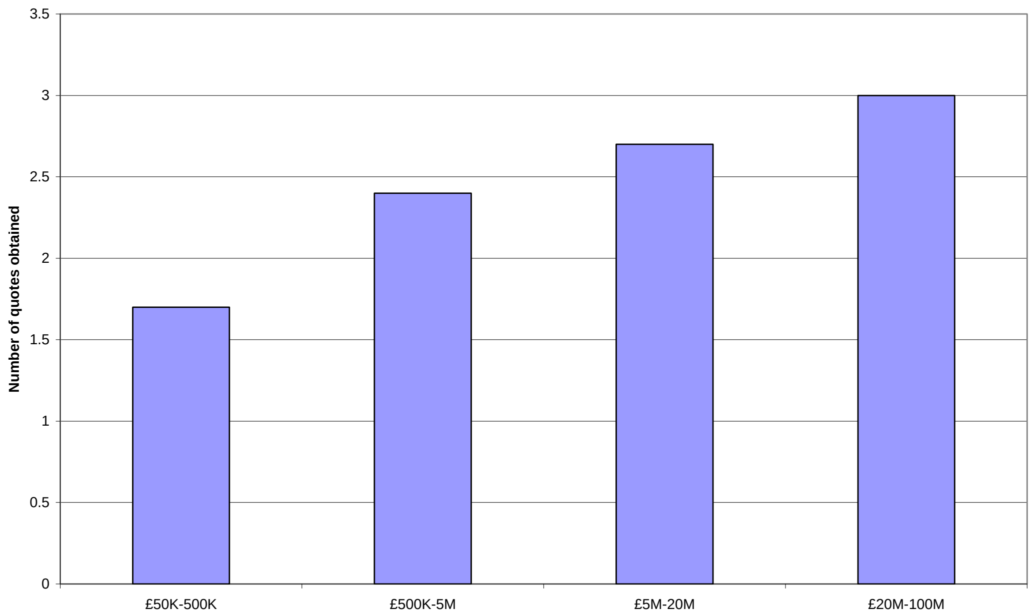
clients to invest significant effort choosing their intermediary but then to stay with them for a significant period of time.

4.3.5. Selecting insurance cover

When considering the process by which insurance cover is selected, evidence in the client survey identified that the number of quotes presented to the client rises with the size of the company. For the smallest companies, a single quote may be presented and it may even be the case that renewal happens automatically without the client or intermediary actively making a decision.[60]

For the largest companies, discussions with intermediaries regarding renewal and cover will often start many months before the renewal date. Many of these customers will have their own models which provide information regarding their insurance needs and may also use peer reviews or external consultants to review their needs as a further check on their intermediary. Intermediaries will usually present a number of different quotes although many of these companies will often be directly involved in the discussion with the insurers. This is because these clients believe they are in the best position to “sell” the nature of their business to the insurance companies by helping to explain claims history and the underlying risks of the business.

Figure 12: The number of quotes commonly presented



Source: CRA analysis

60 Based on case study interviews.

The role of the client in ensuring there are a range of competing quotes also varies dramatically by size of company. Multiple quotes were requested 50% of the time by companies over £500,000 but only 20% below this.

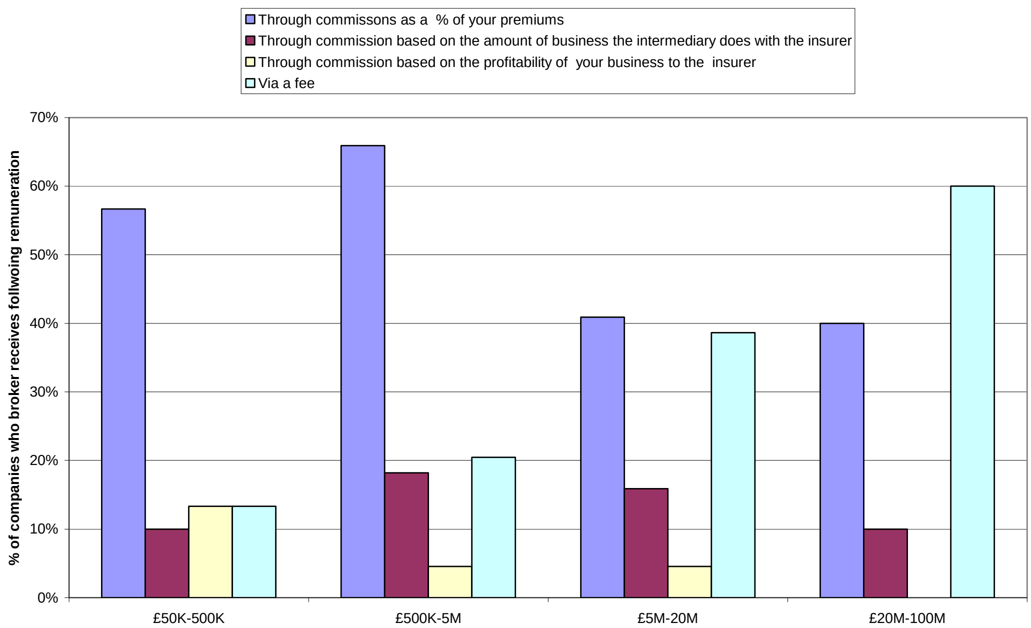
Retention of insurer is also relatively high with around 80% using the same insurer as previously.

4.4. REMUNERATION OF INTERMEDIARY SERVICES

The way that an intermediary is remunerated varies significantly by size of company. The LCCs all pay their intermediary through a fixed fee, often agreed annually, taking into account the likely level of activity. Smaller companies are more likely to use commission to pay for their intermediary.

As seen from Figure 13, among businesses with a turnover of £20-£100 million around 60% are paying intermediaries a fee while even among businesses with a turnover of less than £500,000, 10% are paying on a fee basis. Interviews with intermediaries indicated that clients with insurance premiums of over £50,000 would be likely to be using fees.

Figure 13: Remuneration of intermediary by size of client



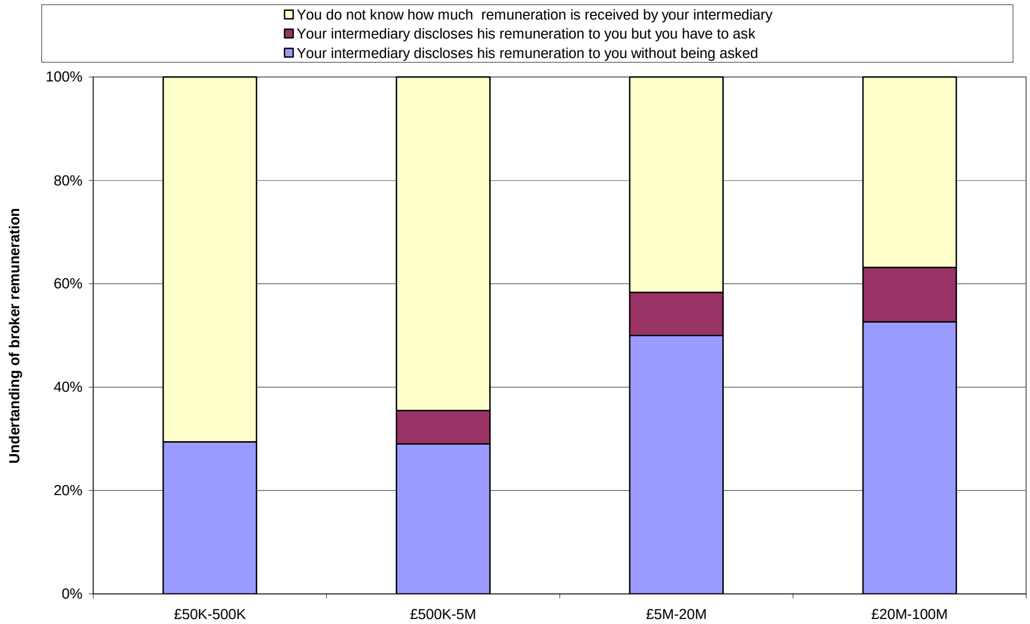
Source: CRA analysis

From Figure 13, it is also clear that some clients are aware that the intermediary is receiving contingent commission. However their awareness of contingent commission payments may not necessarily coincide with the actual use of such arrangements.[61]

61 This result therefore needs to be examined in the light of evidence from section 3.5.3.

As seen in Figure 14 below, the awareness of how much the intermediary is being paid increases directly in line with the size of the client. Only around 30% of micro-enterprises are aware of how much their intermediary is paid through commission, but this rises to 60% for larger SMEs. The illustration also shows that the information disclosed is usually provided voluntarily by the intermediary. Around 10% of the larger companies must proactively ask for the information.

Figure 14: Information regarding the level of intermediary remuneration



Source: CRA analysis

The small proportion of clients requesting information is consistent with evidence obtained in the compliance cost survey which also sought information regarding the frequency with which intermediaries are requested to provide commission disclosure. Among those intermediaries that did not automatically disclose such information:

- 75% of responding intermediaries stated they had never had a request for disclosure;
- 15% of intermediaries stated that less than 1% of clients had requested disclosure; and
- the remaining 10% of intermediaries stated that between 1% and 5% of clients had requested disclosure.

LCCs interviewed claimed to be aware of how much they were paying through fees and whether there was additional remuneration earned by the intermediary. However, interviews with the largest companies also revealed that the Spitzer investigation had a dramatic effect on the disclosure of information suggesting that even sophisticated clients did not previously understand all of the compensation arrangements.[62] Indeed a number of large companies suggested that the “right” question had to be asked for the intermediary to reveal “full” information. Some of these clients also check with insurers directly as to whether there are any additional payments to the intermediary by the insurer. Other large companies request to see the slip so that they can check the commission terms that had been agreed.

We find that around 10% of companies obtain rebates from intermediaries. This figure rises to 20% for the two largest SME categories where fees would be most prevalent.[63]

Understanding the cost of intermediary services

A further way of testing whether clients understand the price they pay for their intermediary, is to ask them what they see as a reasonable charge for these services and compare this to the actual level of commission paid in the market and the results of this are presented in Figure 15. This shows that:

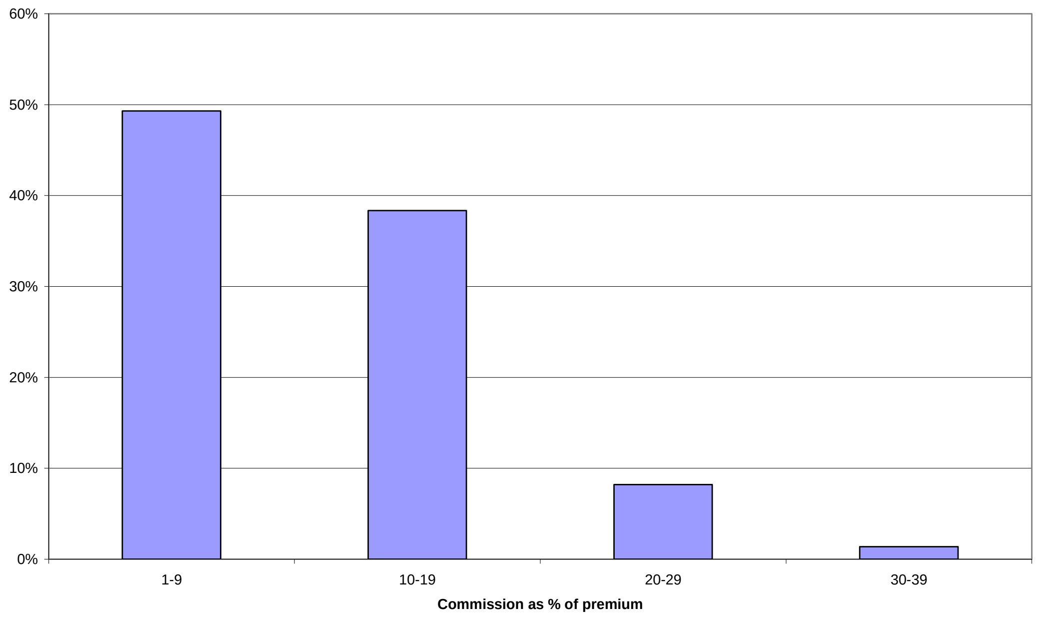
- 50% of companies believe they should be paying between 1-9% for the services of their intermediary; and

- 38% believe they should pay between 10-20%;

62 This was also supported by interviews by some of the intermediaries involved in the Spitzer investigations, who indicated that some clients did discover the presence of additional payments that they had not previously been aware of.

63 The way remuneration is disclosed has also changed due to Insurance Premium Tax (IPT). Previously, large companies paying fees would pay gross premium and the commission would be rebated by the intermediaries. Changes in IPT have made it more efficient to pay net premium, although this is not necessarily standard practice.

Figure 15: Reasonable expectation regarding commission



Source: CRA analysis

Across the sample, clients believe that 10% would represent a reasonable level of remuneration. This is not necessarily the same value as the amount that clients think they are paying. However, it would be surprising if clients believed that the level of commission that they paid was unreasonable and yet were not planning to switch intermediary in the light of this.

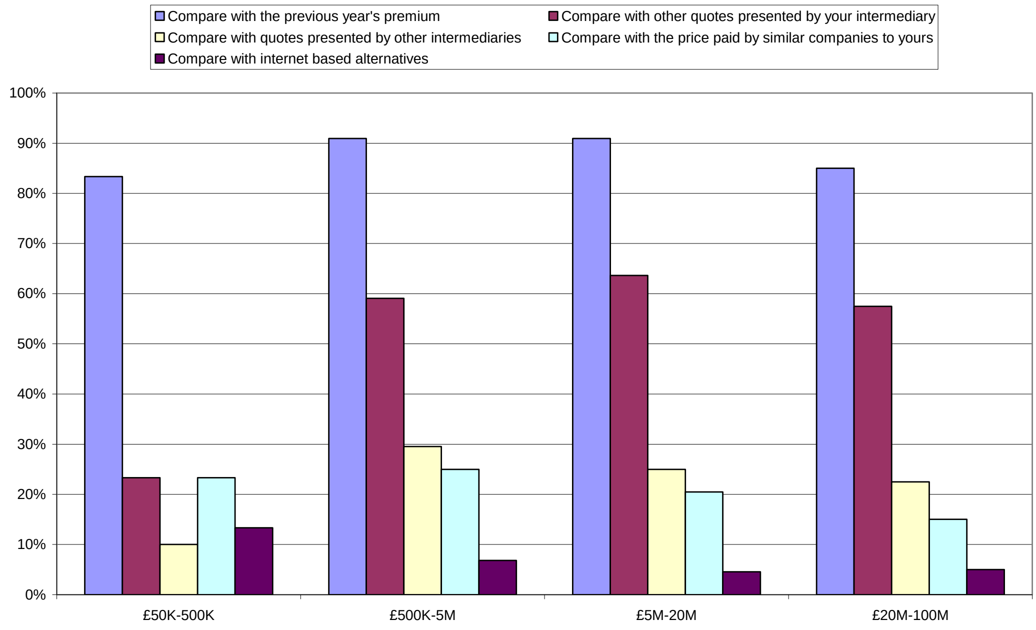
Evidence presented in section 3.5 finds that the actual level of commission is closer to 20% on average, and can be higher where there are contingent arrangements in place. Thus there is a clear discrepancy between what micro-enterprises and SME clients believe is reasonable and the level of commission that they are actually paying in practice. This is also supported by a client survey by IUA which found that clients pay intermediaries twice as much as they think they do.

LCC knowledge of intermediary remuneration was dramatically greater than for smaller companies. This reflects the relative importance of, and level of expenditure on, insurance. LCCs often have a team of dedicated staff responsible for purchase and management of insurance. In addition to the time that these staff spend on insurance issues, the team is often composed of former intermediaries and insurers.

4.4.1. Assessing value for money

Having a detailed understanding of the remuneration of intermediaries is not the only way that competitive discipline may be applied to intermediaries. If there is substantial competition on the value of gross premiums, the price paid for intermediary services will be indirectly constrained. Figure 16 shows how companies determine whether the insurance they are offered by their intermediary is good value.

Figure 16: Process for assessing whether insurance is good value for money



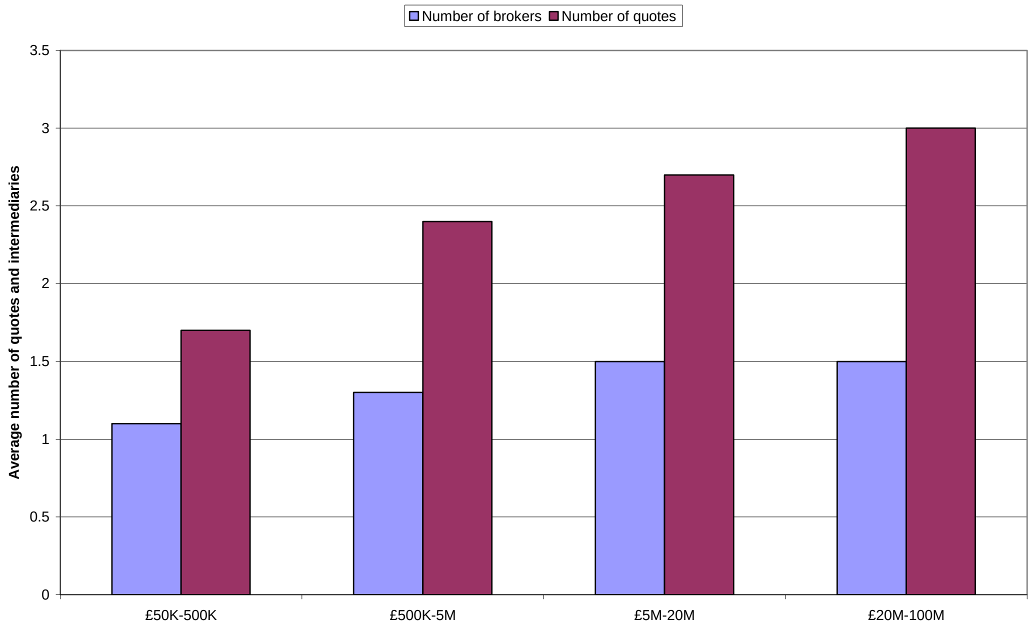
Source: CRA analysis

The most common method of assessing value for money is to compare premium levels with previous years. If the premium is similar to or less than the prior year, the client believes that they continue to get a good deal, whereas if the premium has increased sharply they are more likely to question whether this represents value for money. This implies that competitive pressure may vary according to the position in the insurance cycle.

The smallest companies are more likely to check offerings on the internet when determining whether premiums are reasonable - supporting the view that the direct channel represents a realistic substitute to intermediaries for small clients.

The larger the company the more likely they are to request multiple quotes or even obtain a quote from another intermediary (this may be an informal process of checking whether the current terms are reasonable rather than a formal intermediary selection procedure).

Figure 17: Getting multiple intermediaries or quotes



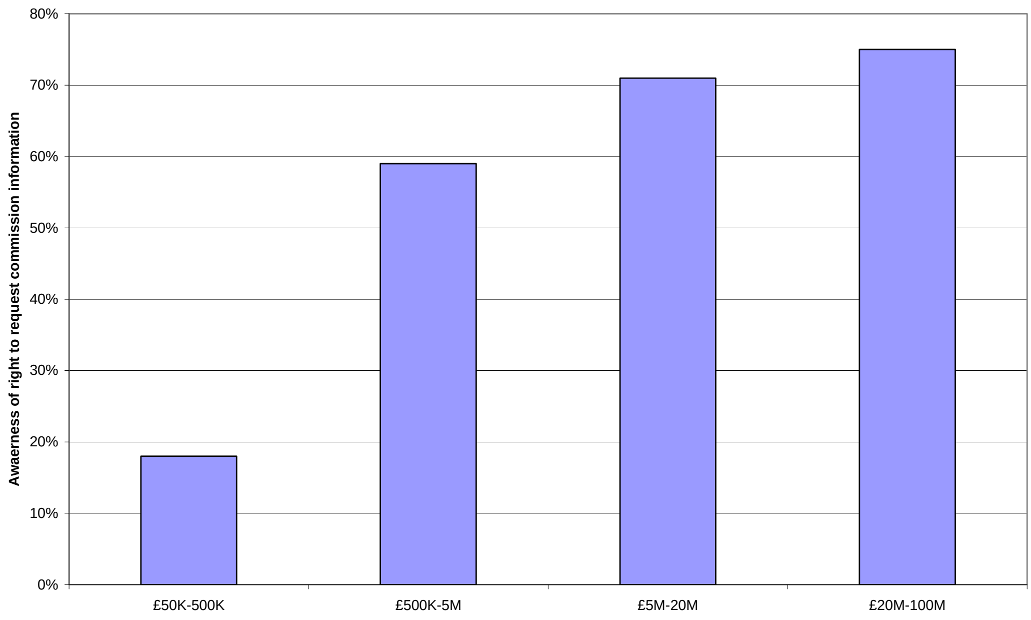
Source: CRA analysis

The great majority of clients (75%), however, use the services of only one intermediary with only 20% using two intermediaries. Even when multiple intermediaries are used, this is most commonly due to the specialisation the additional intermediary can bring to the client. Therefore the number of intermediaries used reflects the complexity of their needs, rather than a mechanism to check the remuneration of their intermediary.

Information regarding intermediary remuneration

Currently, intermediaries only have to disclose commission if they are requested to do so by their client. As indicated in Figure 18 below, there is considerable variation regarding the awareness of these rights.

Figure 18: Awareness regarding the right to request commission information



Source: CRA analysis

It is clear from Figure 18, that there is very poor awareness of the right to request commission among the micro-enterprises. Although there is substantially greater awareness among larger firms, 25% of those firms with a turnover of £25-100million are not aware of their right to request commission information. All of the LCCs interviewed were aware of their right to request such information and would expect such information to be disclosed to them.

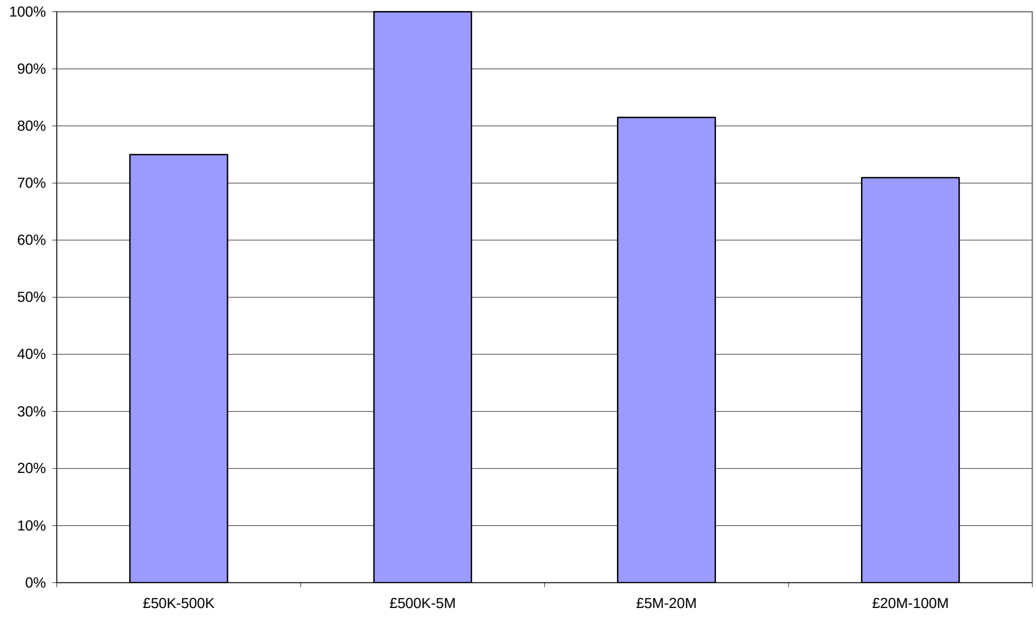
4.4.2. The use of information

Those who were unaware that they could ask for commission to be disclosed were asked whether they would subsequently seek this information. On average 44% of clients would subsequently seek information on commission to be disclosed once they are aware that they can ask for this information.[64]

However, even if clients are aware that they can get information on the remuneration of their intermediary, it does not mean that they use the information that they receive.

64 The proportion who would ask for this information decreases slightly as the size of the company increases but increases slightly as the expenditure on insurance increases.

Figure 19: Did not use information provided on commission



Source: CRA analysis

It is very clear from Figure 19 that the great majority of those who currently receive commission information do not use it. Overall 81% do not use the information on commission that they receive. Thus providing information to clients does not always result in clients using such information.

5. MARKET FAILURE ANALYSIS

In the preceding chapters we have set out the potential sources of market failure from a theoretical perspective and examined both the supply and demand sides of commercial insurance and intermediation. In this chapter, we bring this evidence together to consider whether there is a substantive market failure in the commercial general insurance market arising from a lack of transparency in intermediary remuneration.

It is important to note that even where a substantive market failure exists, it does not mean that mandatory commission disclosure would be an appropriate regulatory intervention – assessing whether this would result in benefits that outweigh the costs of intervention is considered in chapter 6.

In order to determine whether there is a substantive market failure we have found it useful to look at how the market works for different types of client.[65]

5.1. MARKET SEGMENTATION

As set out in chapter 4 we have found that the needs of different types of clients vary significantly in terms of the complexity of the insurance products and the types of intermediary services they use.[66] The result of this is that the basis of competition differs across these market segments and with it the potential for market failure. We segment the market into three:

- Micro-enterprises: These companies have an annual turnover of less than £500,000. Business conducted in the smaller end of the market tends to involve standardised risks and commoditised products (closer in nature to the retail market as they share common policy wording and homogeneity in risks faced by different companies[67]). The purchase of insurance is not undertaken by risk specialists but it is rather a small component of another role (most likely the owner-manager). The result is that these clients are also the least financially sophisticated. Although traditionally these clients have used intermediaries to access the market, they put the least value on the wider

65 It is worth noting again that we use the standard economic definition of "market failure" to mean where markets do not function efficiently. The FSA defines market failure as occurring when there is an economic case for regulatory intervention.

66 For each of these market segments, we have considered the range of intermediaries and insurers who serve this market segment and the way that clients decide on the appropriate type of channel, advisers and product. We therefore consider substitutability but we have not formally defined economic markets. Defining economic markets, as used in competition investigations, involves defining both product markets and geographic markets. We have not attempted to do either of these. We note that the insurance "market" will be characterised by a very large number of product markets meeting the different needs of different clients. Different types of insurance meet different client needs and hence are not likely to be substitutes for each other. We would not therefore expect them to be in the same product market.

67 We are using the FSA definition of retail insurance to mean personal lines insurance.

range of services offered by the intermediary. This is the market that has the highest penetration of direct business and where this is expected to grow in the future.

- Middle-market: These companies generally have a turnover between £500,000 and £100 million. Risks are typically complex and insurance bespoke, while the buyers of insurance tend to be relatively unsophisticated (i.e. they are normally non-risk management specialists such as the finance director or company secretary). The companies in this middle segment are more likely to be served by regional intermediaries, of which there are thousands. The essence of the intermediary's role, as seen by both intermediaries and customers, is the provision of needed advice on coverage, policy wordings, and searching the market for the best value product.

- Large corporate customers (LCCs): Complex large risks require complex risk management and bespoke cover and necessitate the need for advice. The large corporate customers may operate on a global scale, and often have very large and complex risks both in terms of physical assets (aircraft, oil platforms, etc) and various forms of liability (worker safety, customer safety, etc). With the benefit of scale, large corporate clients are able to employ sophisticated professional risk managers. Most of these companies will use the international intermediary firms that have global scale and sufficient sophistication to adequately respond to all of their needs.

It is convenient to define the segments in terms of revenue bands and the characteristics described above apply to the majority of firms in this band. However, it is important to note that there will be variation within the segments. The sophistication of the insurance buyer varies between companies of the same size which is at least partly due to the risk faced by the industry and the corresponding importance of insurance. So for example, 60% of the largest firms in our middle segment use fees and 23% of the smallest firms in our middle segment are buying direct.

For each of these segments we first review the evidence on the amount of disclosure undertaken by intermediaries and the types of remuneration being paid and whether the lack of transparency results in substantive market failure.

5.2. MICRO-ENTERPRISES

In this segment, there is little disclosure. Micro-enterprises show little awareness of commission arrangements with only about 30% of these companies knowing the commission paid to their intermediary (and none of the companies proactively asking for this information). The smallest companies show the least interest in their intermediary's remuneration, however, this is partly due to the smallest companies being unaware that they can ask for information about their intermediary's commission (which they are able to under the current rules).

This segment has seen the highest penetration by direct and internet offerings at the expense of traditional intermediaries. Customers are primarily attracted to the low premiums that the direct writers offer because they believe the inexpensive distribution method will result in them getting a better deal. Customers who purchase direct obtain and compare several quotations over the internet (on average they gather between two and three). Our customer survey indicates that about 50% of the smallest companies in this segment conduct some of their business directly via the internet, with the remainder using intermediaries. There was agreement among industry interviewees that the penetration of direct channels would continue and it would become more important even for the larger clients in this category. This trend will also be encouraged by intermediaries choosing to focus their efforts on larger customers (in other market segments) as can already be seen by some intermediaries withdrawing from serving micro-enterprises. However, penetration can only go so far - even relatively small companies value advice from intermediaries and can have risks which are not easily underwritten by automated systems used by direct insurers.

Where micro-enterprises are using intermediaries, they are the least likely to use a competitive tender to choose their intermediary but instead are likely to choose their intermediary based on the recommendation of a peer or a recommendation by a trade association. We find that micro-enterprises have the highest retention rate and are only likely to consider changing intermediary if their current intermediary does something wrong. However, although micro-enterprises are less likely to get additional quotes from other intermediaries or demand that their intermediary offer multiple quotes, they are more likely to use external reference points to assess whether the insurance they are offered is good value. In particular, they are more likely to compare quotes offered to similar peer companies (23%) and to compare quotes available on the internet (13%) than other segments. Although micro-enterprises still using intermediaries are unlikely to be aware of the cost of their intermediary, given the growth of the direct channel this is likely to become a smaller issue over time (with even those continuing to use intermediaries comparing the total cost to the direct channel). Therefore, although there are concerns that micro-enterprises who continue to use intermediaries do not switch intermediaries resulting little competitive discipline, this problem is also likely to diminish over time.

Where micro-enterprises are using direct channels or testing the advice of their intermediary by getting direct quotes (as is the case with over 50% of them), it is unlikely that non-disclosure leads to detriment from customers paying inflated premiums or there being a problem involving product or provider bias.

Finally, given that micro-enterprises are largely not seen as valuable clients for international intermediaries given the size of their premiums and the types of standardised homogenous risks they entail, it is unlikely that any potential problem associated to intermediary chains or issues to do with the competition between regional and international intermediaries will cause significant detriment.

Overall, we conclude that there are no substantial market failures in the micro-enterprise segment.

5.3. MARKET FAILURE FOR THE MIDDLE SEGMENT

Clients in the middle segment have complex needs and therefore using the direct channel which is designed for more standardised risks is not appropriate. Similarly, substitutes to insurance such as captive insurance companies and alternative risk transfer products are not commonly used by this segment. Thus, clients in this segment are reliant on intermediaries.

The client survey found that intermediaries of approximately half of the companies in this segment disclosed their commission (with around 10% of companies requesting the information).

Understanding the cost of intermediation

These clients understand that they are paying for their intermediary through commission. However, there is a substantial difference between the amount that clients believe they are paying in terms of commission (on average around 10%) and the amount they actually pay (on average around 20%).

These customers are often using intermediaries that receive contingent commission and these clients underestimate the prevalence of contingent commission. Evidence from interviews and disclosure documents provided to us also indicates that there is typically no disclosure of the amount of contingent commission although intermediaries will disclose that other forms of commission beyond the standard amount exist. Contingent commission may therefore be contributing to a market failure as they are not understood by clients and may exacerbate the confusion clients experience regarding the level of commission they are paying.

Competition for intermediaries

The fact that clients are generally unaware of how much their intermediary costs does not necessarily mean that these costs are unconstrained. Clients choosing on the basis of gross premiums could still choose to go to an intermediary offering cheaper insurance (which the intermediary may be able to offer because they accept lower commission). The evidence, however, does not appear to support the notion that there is intense shopping around on the basis of gross premiums:

- These customers are unlikely to actively search for a new intermediary. Switching rates are less than 10% and over 50% of clients had always used the same intermediary. While clients will ask intermediaries to provide multiple quotes they do not get quotes from different intermediaries and neither do they generally compare quotes to the direct channel.

- The level of gross premiums for insurance products is cyclical and clients appear to focus their attention on whether premiums are similar to last year or whether they are rising significantly. This will put pressure on intermediaries when premiums are rising but clients will pay significantly less attention when quotes remain at a similar level. This does not support a view that clients maintain competitive pressure on their intermediary through monitoring the premium (although it does suggest that there is pressure during parts of the insurance cycle).

- Recent developments in the market driven by intermediary consolidation and work transfer would be expected to have led to cost efficiencies (since otherwise there would be no incentive for the insurer to transfer work to the intermediary). However, while these trends may have resulted in significant increases in commission levels for certain intermediaries there is no evidence that the benefits from cost efficiencies have been passed on to clients in the form of lower premiums (neither is there evidence that higher commission terms have resulted in higher gross premiums paid by clients).[68]

- Stated preference data from clients suggests that if made aware of the cost of their intermediary, they would choose to pay on a fee basis or find another intermediary.[69]

There is therefore a significant amount of circumstantial evidence that some clients are over consuming the services of their intermediary or paying more than they currently believe these services to be worth.

Chains

Middle segment clients are largely unaware of chains being used to service their needs. The lack of commission transparency could contribute to this problem as clients are unaware of chains being used or the amount paid to different intermediaries. If made aware of a chain, clients might choose to approach the wholesale intermediary directly (if the wholesale intermediary was willing to deal directly with them).

However, the evidence suggests that long chains are not common in the domestic UK market. Where they exist they appear to be serving an economic purpose such as providing access to the Lloyds market, access to specialist knowledge or access to specialist products. Furthermore, constraints are imposed on their length because of a reluctance to split remuneration with another intermediary and a desire by insurers to control the risks of long chains

Moreover, the use of chains appears likely to diminish in the future. Regional consolidation may reduce the need for chains as the some larger regional intermediaries have their own Lloyds broker in-house. At the same time, insurers are building regional sales teams to attract primary intermediaries directly. We therefore do not believe that there are significant problems associated to intermediary chains in the middle segment.

68 It is questionable whether this is a sustainable position in the future. Even if this was the case, if activities have moved from the insurer to the intermediary reflecting improved efficiency, this should also have generated some advantages for the client. That we have seen little evidence of premium decreases for these clients is consistent with muted price competition in this market.

69 If competition on gross premium was effective then revealing the proportion of this gross premium that was paid to intermediaries should not alter the behaviour of clients.

Biased advice[70]

Commission payments could introduce the potential for bias in the advice provided by the intermediary in terms of over selling insurance, selling the wrong type of insurance or the wrong provider of insurance. During the course of our work, it has not been possible to test directly whether the amount of insurance purchased is reasonable. Types of insurance are clearly differentiated and there has been no evidence that suggests that clients believe they are being sold insurance they do not need. Interviews with small and medium size clients and the relevant trade associations did not identify concerns regarding the amount of insurance purchased.

Intermediaries could choose to use insurers that offer them a higher level of commission which may result in a reduction of the quality of the insurance or a higher price for that insurance and therefore result in detriment for the client. Volume based contingent commission is a particular concern since this could result in significant incentives when the intermediary is approaching a volume threshold.

This project has not examined whether there is any direct evidence of contingent commission leading to provider bias. Based on interview evidence, clients who are aware of contingent commission were not concerned regarding the incentive this provided to the intermediary. However, it is clear that contingent commission contributes to the problem that clients are unaware of the amount their intermediaries are being paid.

Related to the issue of provider bias is the use of binding authorities and panels. Given the cost of search, both of these mechanisms may be efficient methods to reduce costs of searching the whole market for every customer by searching the market when choosing the insurers who offer a binding authority or who will be included on a panel.

However, these mechanisms also allow intermediaries to focus their business with a number of providers and remuneration could be one of the factors used to choose the insurers on the panel or ultimately to operate as an MGA.

We find that the vast majority of clients believe that they are using an intermediary who can search the whole market, whereas evidence from intermediaries suggests that only 60% of intermediaries do so for micro-enterprises and SME clients. We have not investigated this issue any further as it is outside the scope of our analysis, although further investigation may be required to assess whether this represents a market failure. It is, however, possible that clients are over-estimating the service they receive (at the same time as under-estimating the price they pay).

Inefficient activities undertaken by the intermediary

MGAs are also important when thinking about work transfer. When intermediaries undertake activities that are traditionally performed by the insurer, they need to be

70 It should be noted that we have focused on qualitative evidence regarding the existence of bias Statistical analysis testing for the existence of bias was outside the scope of this assignment.

compensated for these services. Work transfer could represent an efficient division of labour between the insurer and the intermediary, alternatively it could simply reflect an increase in the payment to the intermediary with little change in the activities of either party.

Payment for work transfer is occurring in parts of the market where there is currently little commission disclosure. Hence it seems unlikely that such payments are designed to "get around" constraints imposed by commission disclosure. However, while there does not appear to be reason to be concerned about such payments today, if there was mandatory commission disclosure, the interaction between disclosure and payments for work transfer arrangements could represent a problem (we return to this in the next chapter).

Distortion of competition

Whether there is a level playing field between intermediaries who are disclosing and those who are not is a concern often raised about the middle market. There is concern from some intermediaries and insurers that they cannot compete for middle market customers as they do not accept contingent commission and already disclose commission. As the middle market is served by both international intermediaries (who do not accept contingent commission and commonly disclose) and regional intermediaries (who commonly do accept contingent commission and will typically not disclose to clients) this could be a significant distortion.

Based on the interviews undertaken for this project, there are a number of potential reasons why regional intermediaries are successfully competing in the middle market. In particular, they would argue that they have invested in the market, improving client service and building on the trusted relationships they have with their clients. They also argue that by consolidating existing businesses they are able to negotiate terms with large insurers, at least as favourable as the leading international intermediaries. The net result of which is that they are offering products with competitive terms.

It seems unlikely that disclosure is highly detrimental to the international intermediaries in the middle market. They continue to have a significant share in this market, clients are not currently using the disclosure to a significant extent, and if they were more efficient than the regional intermediaries they could compete through offering lower premiums. They do, however, bear an extra burden of cost (of disclosure) compared to non-disclosing intermediaries.

We therefore do not believe that a concern about distorting competition provides a further justification for mandatory commission disclosure.

5.4. LCCs

LCCs are sophisticated purchasers who typically employ specialised risk managers with responsibility for their insurance needs. These individuals have often previously worked as intermediaries or for insurance companies and their presence substantially reduces the information asymmetry between the client and the intermediary.

These clients also have viable substitutes to insurance in the form of self-insurance, captive insurance companies and alternative risk transfer products ensuring that additional competitive pressure is applied through comparisons with these (although this would not apply across all of their insurance needs).

Competition for intermediaries appears robust, although retention remains high. LCCs build relationships with a number of intermediaries, review their relationships every three to four years and are willing to switch if necessary. In this selection process, although experience and services are the most important elements, the remuneration of the intermediary is important.

LCCs primarily pay intermediaries through fees and expect commission paid by insurers to be rebated. In particular, clients are aware of the cost of their intermediary and it therefore seems unlikely they are purchasing services they do not require. Furthermore, payment by fees means that there is little reason to be concerned regarding their incentive to sell unnecessary insurance to these clients, propose inappropriate products or the wrong provider. Indeed, many of these customers will have their own models which provide information regarding their insurance needs and may also use peer reviews or external consultants to review their needs as a further check on their intermediary.

In addition, many of these customers are involved in the purchasing process and may be meeting directly with the insurers. It therefore seems unlikely that they are unaware of any chain being used (although the presence of a chain is less likely for large clients who use large, integrated, intermediaries) or willing to tolerate intermediaries performing activities that could best be undertaken by others. Some LCCs will use multiple intermediaries where particular expertise is required.

Finally, LCCs are served primarily by the large international intermediaries who are seen to have the expertise and breadth to meet the full range of their needs. The concern about an unlevel playing field between these intermediaries and others does not, therefore, appear significant for these clients. Since these intermediaries are not using contingent commissions and have introduced disclosure, LCCs appear to have a good understanding of the remuneration of their intermediaries and have learned about the potential for conflicts of interest caused by commission (contingent or otherwise).

Overall, we conclude that there are no substantial market failures in the LCC segment.

5.5. CONCLUSIONS BY MARKET SEGMENT

In two of the three client segments we find little evidence of market failure:

- Micro-enterprises (companies with turnover less than £500,000): These customers account for around £3 billion gross written premiums (GWP) or 17% of the market. The lack of sophistication amongst these buyers increases the risk of an informational market failure. However, 50% of these companies already purchase directly from insurance companies using the internet or by telephone rather than via an intermediary. The strong growth of the direct channel and the withdrawal of intermediaries serving this segment will continue to mitigate potential problems of non-disclosure. Clients who use an intermediary are able to compare the gross premium with that in the direct channel preventing detriment arising from high prices. We do not believe that market failures in this segment are substantive.

- Large corporate customers (LCCs - companies with annual turnover greater than £100 million): These customers account for around £5.5 billion GWP or 31% of the market. Large customers typically use fees and employ risk managers – which reduces the potential for information asymmetries. They also have access to substitutes to traditional insurance such as captive insurance, self-insurance and alternative risk transfer products. They are mainly served by large international intermediaries who already disclose their remuneration. Given this disclosure and because there is competition on fees, we believe there are no substantive market failures in this segment.

We have, however, identified a “middle segment” of commercial clients (companies with annual turnover between £500,000 and £100 million) who are at risk of suffering detriment from non-disclosure. Clients in this segment do not typically pay fees to their intermediaries but instead intermediaries receive commission from insurers.

Clients in this segment are reliant on intermediaries because they have complex needs and substitutes to insurance such as captives are not viable alternatives. These clients rarely switch intermediary and typically believe that commission is around 10%, when in practice it is closer to 20%, suggesting that competition based on the cost of advice is not strong. These customers are also unaware of their intermediaries’ frequent use of contingent commission, which introduce potential incentive problems. Although disclosure could (in theory) reduce or eliminate many of these problems, these clients rarely exercise their right to know intermediaries’ compensation levels suggesting they lack interest in this information (although one-third are unaware of their right to ask).

Competition over gross premiums could mitigate any problems in intermediary remuneration, although it does not appear to overcome them. Competitive pressure varies over the insurance cycle – with clients paying more attention to gross premiums when they rise, but less attention when they fall. In addition, recent consolidation in the intermediary market would be expected to generate cost efficiencies, but has had no discernible impact on gross premiums. In well functioning competitive markets we would expect cost efficiencies to be passed onto customers through lower premiums.

We therefore conclude that there is a market failure in this middle segment resulting from non-disclosure. However, this only affects clients who do not already remunerate intermediaries with fees, do not actively compare prices with direct channels, and who are not currently disclosed to.[71] We estimate that this segment represents around 10% of

71 The trend to the direct channel by micro-enterprises and the use of fees by LCCs means that we exclude both of these segments from the customers affected by market failure.

commercial clients.[72] Consumer detriment will arise through higher commission and lower value products than in the absence of market failures.Table 9 below briefly summarises the evidence from this section in terms of the different types of market failure that might arise and the different client segments.

Table 9: Evidence of market failure

Potential market failure	**Evidence**
Client underestimates cost of intermediary's services and may over pay or over consume	LCCs are paying on a fee basis so there is little concern
	Middle market customers believe they are paying 10% commission, whereas they are likely to be paying 20%. Intermediaries do not disclose the monetary value of contingent elements of compensation. Clients compare quotes but do not regularly compare intermediaries and largely do not base their decisions on remuneration
	Micro-enterprises are least financially sophisticated and least likely to change intermediary. However, the trend towards direct channels and intermediaries moving out of this market place reduces the potential for detriment
Weak competition for intermediaries	LCCs use competitive tenders to select intermediaries based on experience, past service and remuneration. Given the value placed on experience this results in high retention rates but the market is clearly contestable
	Middle-market customers are unlikely to change intermediary unless there is clear dissatisfaction. Customers are unaware of the cost of their intermediary. Although there is some focus on gross premiums, its intensity depends on the insurance cycle. There is little evidence than consolidation has resulted in benefits being passed onto clients
	Micro-enterprises are inert and do not go through a formal intermediary selection process. However they are increasingly comparing price to direct offerings
Inefficient use of chains	LCCs often have direct relationships with insurers and are aware of the role of intermediaries. Risk managers will often agree the selection of insurers and attend meetings with them. Different intermediaries may also be used for different specialisms
	In the middle market, chains occur when regional intermediary approach Lloyd's intermediaries or specialist intermediaries in order to access niche insurance markets. Clients are largely unaware of the role of wholesale intermediaries or the relative remuneration across the chain. However, there is no evidence that chains are used to reduce transparency of commission. Indeed, there is a trend for regional intermediaries to bring skills in-house
	Chains are not involved in placing the majority of micro-enterprise business which is highly commoditised
Biased advice – Quantity of insurance	LCCs have their own models determining their insurance needs, use peer companies and external consultants to review their needs. Operating on a fee basis limits the incentive to oversell by the intermediary
	Middle-market is most reliant on intermediaries to advise on risk. Clients understand that intermediaries are remunerated on a commission basis and may therefore take

72 This is calculated using DTI data on firm size and evidence from our client survey regarding the level of disclosure going on in the market today. DTI statistics suggest there are 1.3 million employers and that there are around 430,000 employers in the middle segment (based on those who have an average turnover of £0.5-100 million. Assuming that 60% of these firms have commission disclosed to them already, we estimate that around 170,000 employers or approximately 13% of companies would be affected.

	this into account when considering the quantity of insurance to purchase. However, it is impossible to test directly whether the level of insurance is reasonable Micro-enterprises are often purchasing simpler products (sometimes on a compulsory basis). They are vulnerable to biased advice by their intermediary but are increasingly making their own decisions regarding their needs when purchasing direct from insurers
Biased advice – Type of insurance	LCCs have their own models determining their insurance needs, use peer companies and external consultants to review their needs. Operating on a fee basis limits the incentive to oversell by the intermediary Middle-market is most reliant on intermediaries to advise on risk. Clients understand that intermediaries are remunerated on a commission basis and may therefore take this into account when considering the type of insurance to purchase. Products are clearly differentiated and there is no evidence that intermediaries push different products because of different commission levels Micro-enterprises are often purchasing simpler products (sometimes on a compulsory basis). They are vulnerable to biased advice by their intermediary but are increasingly making their own decisions regarding their needs when purchasing direct from insurers
Biased advice – Provider	LCCs have their own models determining their insurance needs, use peer companies and external consultants to review their needs. Operating on a fee basis limits the incentive to oversell by the intermediary Middle-market faces differing standard rates of commission and contingent commission which provide incentives to steer business. Regional intermediaries are increasingly using panels/binding authorities with resulting higher commission which is consistent with focusing the business. However, we have found no direct evidence that this is resulting in provider bias. Micro-enterprises are often purchasing simpler products (sometimes on a compulsory basis). They are vulnerable to biased advice by their intermediary but are increasingly making their own decisions regarding their needs when purchasing direct from insurers
Inefficient activities undertaken by the intermediary	LCCs are clearly aware of the role played by the intermediary. They may outsource some activities such as claims management to third parties In the middle market there appears to be evidence that intermediaries are developing underwriting capability and taking on the role of a Managing General Agent. It is unclear whether this is transparent to the client. However, this issue is about transparency of status rather than commission and beyond scope of this report The intermediary's role for micro-enterprises is largely limited to provider selection. Little additional services offered

Distortion of competition between intermediaries that do and do not disclose commission	LCCs are served primarily by the large international intermediaries who already disclose commission and clients will expect commission disclosure from their intermediary. These clients are typically paying fees and appear to have a good understanding of any potential conflicts from commission Middle market customers can access both regional intermediaries (still commonly using contingent commission and not disclosing) and internationals intermediaries (who do not use contingents and do disclose) and hence there is potential for distortion of competition. However, international intermediaries continue to have a significant share in this market, clients are not currently using the disclosure to a significant extent, and if these intermediaries were more efficient than the regional intermediaries they could compete through offering lower premiums. There is therefore little evidence to suggest that differential disclosure distorts competition Micro-enterprises are largely not seen as valuable clients for international intermediaries and it is unlikely that there is a distortion of competition

Source: CRA International

6. COST BENEFIT ANALYSIS

This section of the report describes the results of the high-level cost benefit analysis (CBA).[73] For regulatory intervention to be justified it needs to be the case that:

- a market failure exists which creates significant consumer detriment and this market failure would not be corrected over time; and
- the benefits from correcting the market failure through regulatory intervention exceed the costs.

Before looking at the results of this analysis, we set out how we approached the CBA and the process by which the scenarios to be tested were developed.

6.1. METHODOLOGY AND SCENARIO DESIGN

Discussions with the FSA indicated that there were a number of different ways it could design a mandatory commission disclosure regime. In order to assess the relative merits of these different approaches four core scenarios were developed. The key features of these scenarios are summarised below:

- Scenario 1: Mandatory disclosure of the existing requirements;
- Scenario 2: Mandatory disclosure of total remuneration payable to the primary intermediary in cash terms, including quantification of the maximum value of contingent elements as well as standard commission (where a variant requires the disclosure of this information to the insurer as well as the client);
- Scenario 3: Mandatory disclosure of total remuneration payable to intermediaries throughout the chain in cash terms including the compensation of non-primary intermediaries not captured in Scenario 2 (where a variant requires the disclosure of some of the information post sale instead of pre sale);[74] and
- Scenario 4: Disclosure of commission equivalent by direct insurers. This scenario should be seen as complementary to scenarios requiring mandatory disclosure to intermediaries rather than a stand-alone scenario.

73 The FSA would need to undertake a detailed CBA to assess any proposed amendments to its rules regarding commission disclosure before making such changes.

74 The scenarios allow delegation of the activity of producing commission information to a third party. This may happen, for example, when the intermediary is operating an MGA on behalf of an insurer. In this case the insurer must make certain that the MGA carries out the required disclosure on its behalf.

We initially tested the scenarios through two workshops – one made up of insurers, the other of intermediaries.[75] These groups helped us to refine the technical specifications of the scenarios, define their scope and begin our evaluation of the likely market impacts and the types of costs that would be incurred.

The compliance cost survey was sent to a representative group of both insurers and intermediaries and results presented in this chapter have been scaled to reflect the costs for the whole of the UK market.[76]

The analysis undertaken has assumed that the great majority of international business would be exempt from any regime. In line with the ICOB regulations it was assumed that mandatory commission disclosure is required only when the intermediary in contact with the customer is FSA authorised, the commercial customer is habitually resident in the EEA and for general insurance contracts, the risk is located in the EEA. Unless otherwise noted, this assumption applies in all scenarios and defines the scope of the disclosure regime.

The monetary value of some components of remuneration (in particular profit and volume based commission) is not known with certainty at the time that the insurance contract is completed, so it is not possible to disclose the exact value of these components. For the purposes of this assessment, respondents were asked to assume a requirement that the maximum possible value of such contingent payments (calculated as if no claims were to occur) would be disclosed.

The work demonstrated that there were significant undesirable unintended consequences associated with most scenarios (involving switching to other forms of remuneration or introducing other intermediaries into a chain in order to avoid disclosure), leaving pre sale disclosure of total remuneration throughout the chain (Scenario 3a) as the most viable option. However, the evidence indicates that even this scenario would not lead to benefits that outweigh the costs of implementation.

We review the evidence for each scenario below. In each case we present the details of the scenario as they were presented in the compliance cost survey.

6.2. Scenario 1: Mandatory disclosure of existing requirements

The first scenario represents making mandatory the existing disclosure requirements. This is instead of disclosure only being necessary when the client requests such information, as is the case today.

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75 The workshops involved insurers (including Lloyd's syndicates and large insurers) and intermediaries (including nationals, large and small intermediaries from both the London and regional markets).

76 If there are fixed costs that arise on a "per firm" basis, irrespective of the gross premiums of clients (as seems likely), this approach will underestimate the costs for small intermediaries. Although data was gathered from small brokers, it has not been possible to identify an accurate measure of any such fixed cost per firm that enables us to estimate these additional costs. The compliance costs presented would therefore be expected to underestimate the actual costs of any disclosure regime.

Based on interviews with intermediaries and disclosure documents provided to us, where commission is disclosed today, only the commission paid at the point of sale is disclosed in cash terms. Other payments, such as contingent commission, will typically be disclosed in the form of a sentence stating that “we may also receive additional payments based on…” which may not specify exact details of any payments.

Since this is the current practice of disclosure, we have assumed that this continues in Scenario 1 where disclosure moves from being “on request” to mandatory. A description of scenario 1 can be found in Table 10 below.

Table 10: Mandatory disclosure of existing requirements

Issue	Requirement
Who is responsible for the disclosure?	The primary insurance intermediary is responsible for the content, production and provision of information to the commercial customer.
Information requirements	Mandatory disclosure of existing requirements as in ICOB 4.6 but without the requirement for a request. These would be modified to require that “before the conclusion of a non-investment insurance contract, or at any other time, an insurance intermediary that conducts insurance mediation activities for a commercial customer must, ~~if the commercial customer asks~~, promptly disclose the commission that he and any associate of his receives in connection with the non-investment insurance contract in question, in cash terms or, to the extent it cannot be indicated in cash terms, the basis of the calculation of the commission, in a durable medium.”
To whom should the information be provided	The commercial customer.
When should the information be provided?	Before the conclusion of the contract.

Source: CRA International

6.2.1. Market impacts

As indicated in section 4.4, not all clients currently receive information on their adviser’s remuneration. Hence a mandatory disclosure regime would increase the number of clients receiving such information compared to today. The number of additional commercial customers who would receive this information varies between types of customer and types of intermediary that they use:

- Large clients are mostly choosing to pay their intermediary on a fee basis. This is negotiated with the client and hence already known. Therefore we do not expect to observe a large effect in this part of the market;
- Clients served by the large international intermediaries already receive commission information as these intermediaries disclose this as a matter of course;
- Clients served on a commission basis can be split into two groups:

- Those who are already receiving this information, which is approximately 50% of customers; and

- Those customers who do not receive (or request) commission disclosure information currently and who are mainly small and medium customers operating with small and medium size intermediaries.

Section 4.4 also noted that among those intermediaries that do not automatically disclosure commission, 75% had never received a request for disclosure, with the remaining intermediaries receiving requests from less than 5% of their clients. Since there have been so few requests for information, many intermediaries were unsure exactly how their clients would respond to such information. For example, the same intermediaries believe that:

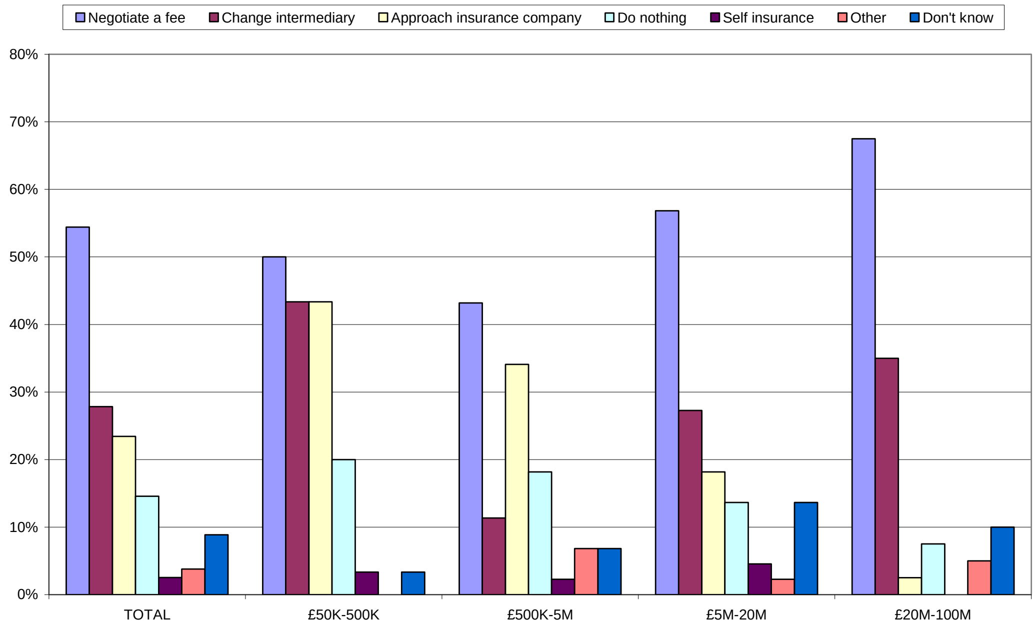
- Their clients focus on the gross written premium since this is the amount of money the client will ultimately pay and that clients are indifferent to receiving information on commission (since they would otherwise request the information) although the clients recognise that this is how their intermediary is paid; and [77]

- If their clients were presented with information on commission, a group of clients would be prompted both to question the intermediary regarding the remuneration (imposing costs on the intermediary in terms of the time needed to explain these things) and also to shop around.

On the face of it our client survey supports the latter conclusion. We asked commercial customers what they would do if they were to discover that intermediary remuneration was twice as high as they estimated it to be. (As noted in section 4.4 , at present clients believe that commission rates are around 10% whereas evidence from the market suggests that they are typically around 20%.) In Figure 20 below we set out the response to discovering that remuneration is twice as high as they previously believed.

77 As indicated in section 4.4, not all clients are aware of their right to request commission disclosure.

Figure 20: If you were told your intermediary was receiving twice the amount of commission for the same premium what would you do?



Source: CRA analysis

Based on how clients *say* they would behave, if commission was significantly more than expected there would be an increased demand for fees, willingness to change intermediary (actually changing intermediary would depend on whether all intermediaries charge similar amounts) but little appetite to self-insure. In addition, smaller companies would be willing to approach insurers directly.

As with all stated preference data based on what clients *say* that they *will* do, there is a concern that customers overstate their willingness to change behaviour such as through shopping around. It is therefore important to look for at what clients actually have done:

- Following the Spitzer investigation, international intermediaries disclosed the amount of contingent commission previously earned. Interview evidence indicated that this led to switching in very few cases – partly because all intermediaries were seen to have the same problems. It is possible, however, that the threat of switching was sufficient for the client to be offered better terms; and

- The client survey finds that 81% of the clients receiving information on their intermediary's remuneration have not used this information at all.

On the basis of this information, it seems reasonable to assume that if clients were made aware of the commission that they were paying their intermediary this would generate some questions, negotiation and possible shopping around. However, data on what customers actually do is preferred to what people say that they will do and therefore in later calculations we use the evidence that only 19% of clients currently use the information that is disclosed to them.

Both insurers and intermediaries agreed that some unintended consequences might arise as the industry sought to mitigate this customer reaction. In particular, the industry would shift commission payments from “standard” commission towards “other” forms of remuneration which they would not disclose in cash terms. These could include profit or volume based contingent commission, payments for services performed by the intermediary on behalf of the insurer, premium financing, etc. As such standard commission might decline across the industry if disclosed, but be compensated by increases in contingent payments that are not disclosed as clearly.

Such a switch from standard commission to other forms of payment could be achieved with little difficulty for many middle market intermediaries (although in some cases this would be reversing a *voluntary* internal policy decision taken within these firms to reduce contingencies in the light of the Spitzer investigation[78]). These intermediaries include larger regionals and consolidators that already have contingent commission arrangements which could easily be increased. Given their size this would not appear to impose a significant cost to either the intermediary or insurer.

However, this is not the case for all intermediaries:

- small intermediaries do not typically have contingent agreements with insurers because of their limited bargaining power. Indeed, insurers stated that only the largest 10% of the intermediary population would typically have contingent arrangements in place. Smaller intermediaries would therefore not be able to shift income from standard commission to contingent commission; and
- the largest international intermediaries cannot accept contingent payments due to decisions made following the Spitzer investigation. They would therefore not be able to shift income to contingent commission despite their large market share.

Shifting remuneration from a standard basis to a contingent basis would therefore lead to several distortions. Some intermediaries would be able to present a low standard commission while also accepting high contingent payments that would not be disclosed in cash terms. If clients shop around on the basis of the disclosed commission level, intermediaries with contingent arrangements could gain business by lowering standard commission.

By contrast, small intermediaries would be faced with a reduction in their standard commission without having any contingent arrangements to compensate for this. This could cause smaller intermediaries to exit the market or to sell their businesses to the middle market intermediaries who do receive contingent payments.[79] This would

78 That is, following the Spitzer investigation, some intermediaries who were not directly involved in the investigation decided that contingent commission was no longer an appropriate form of remuneration and *voluntarily* stopped accepting it. However, since these were voluntary decisions, these intermediaries could decide to reverse this policy if they thought they were being unduly penalised because of it.

79 Although many intermediaries thought this would call into question whether it was commercially possible to continue to serve the UK market, it is not possible to test whether this would occur in practice.

encourage consolidation, not because it leads to more efficiency, but because of the disclosure regime.

Perversely this could also reduce the value of disclosure that is occurring today. Clients who currently request commission disclosure demonstrate by this that they are sensitive to commission. However, if there is a movement to contingent commission, clients who focus on standard commission will be sensitive to (and therefore impose competitive restraint on) a smaller proportion of total commission than compared to today.

Finally, the client survey found that around 23% of clients would consider purchasing insurance direct rather than using an intermediary. For some clients, this could be a rational decision. However, it was claimed by some intermediaries that some customers with more complex needs could make costly mistakes when purchasing without advice. Business interruption insurance was one example frequently given as an example of something that few clients realise may be appropriate (or may not be covered by other policies) but that intermediaries would commonly recommend. This could be a particular risk for clients who switch to purchasing their insurance online without a full understanding of the risks that they face. It has not been possible for us to test this concern.

6.2.2. Compliance costs

Mandatory commission disclosure would not impose any additional costs on intermediaries that either already disclose commission as a matter of course or only operate on a fee basis.

In addition, the FSA already requires that a process be in place to deal with any requests from clients for commission disclosure. However, discussions with intermediaries have indicated that while these processes *are* in place, they are appropriate only to the current level of requests for information (which as noted in section 4.4 is exceptionally small) and are typically manual processes. According to intermediaries, disclosing commission to all clients would require an automated process and hence result in significant changes to current systems.

Interview evidence suggested that the costs of disclosing standard commission would be lower than the costs of disclosure in other scenarios (which incorporate disclosure of contingent payments in cash terms) because standard commission information is currently available in most companies' systems. The results of the compliance cost survey did indeed show this to be the case.

As the responsibility for disclosure in Scenario 1 falls directly on to the intermediary, we believe that there would be no compliance costs that would be borne directly by the insurers (and this was confirmed by the insurer workshop) and hence compliance costs for insurers were not gathered for this scenario. The compliance costs reported by intermediaries have been scaled up to represent the whole of the UK market and are reported in the table below.

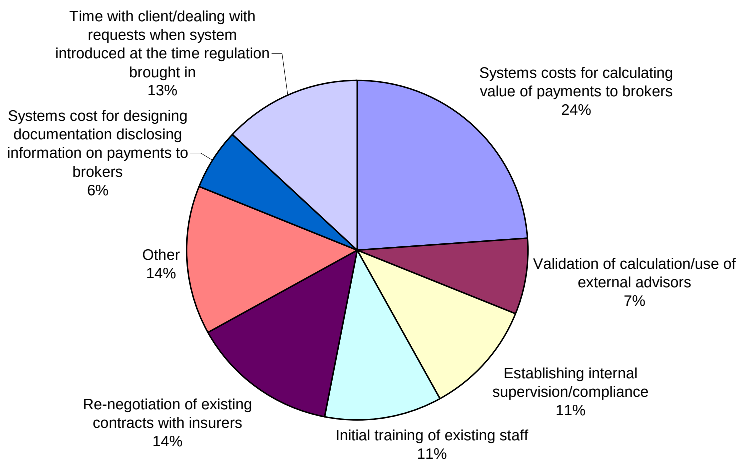
Table 11: Compliance costs for scenario 1

	One-off	Ongoing
Incremental compliance cost (£ millions)	17.4	10.2
As a % of Gross Written Premium	0.10%	0.06%

Source: CRA International

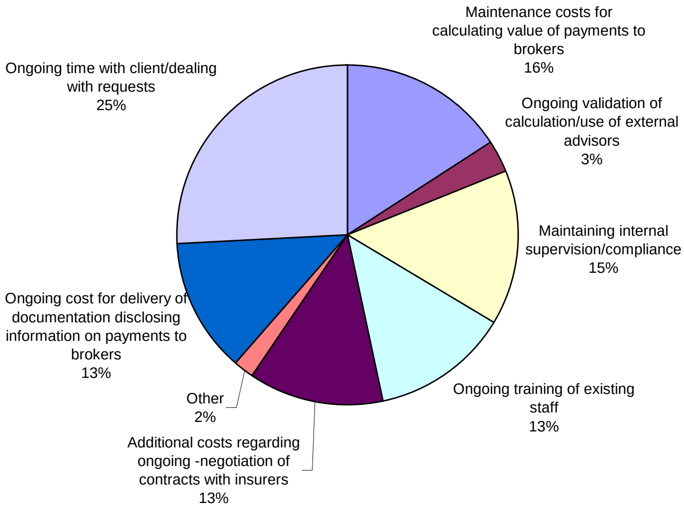
Unsurprisingly given the systems costs, the ongoing costs of this scenario are higher than the one-off costs. Looking at the composition of these costs (as show in Figure 21 and Figure 22 respectively), we find that system costs are a bigger component of the one-off costs and time spent with clients is a bigger component of the ongoing costs.

Figure 21: Composition of intermediary one-off costs for scenario 1



Source: CRA International

Figure 22: Composition of intermediary ongoing costs



Source: CRA International

In as far as this scenario involves changes to systems and processes, it seems likely to represent a greater burden on smaller intermediaries who have a smaller amount of business over which to spread the costs. Indeed, the results shown in Table 12 show this to be the case (although large regional have higher one-off costs than smaller firms).

Table 12: Compliance costs for scenario 1 by type of intermediary as a % of operating costs

	One-off	Ongoing
National intermediary	0.72%	0.68%
Large regional intermediary	3.46%	0.75%
Small regional intermediary	2.63%	1.84%
Small Lloyd's broker	0.29%	0.35%

Source: CRA International. Note that the "national" intermediary category involves more intermediaries than the international intermediaries that already disclose commission information.

6.2.3. Summary of scenario 1

In summary, scenario 1 does not appear to have any clear benefits because of the ability to "get around" the regulations. In particular, any shift to contingent commission and other forms of remuneration could exacerbate the identified market failures and distort competition between small intermediaries and those larger intermediaries able to negotiate other forms of remuneration. Given the lack of clear benefits these would be likely to be outweighed by the small but positive costs.

A summary of the market impacts associated to Scenario 1 is shown in the table below.

Table 13: Summary of impacts in scenario 1[80]

Component of CBA	Summary
Quantity of services	Likely to lead to a switch from small intermediaries to larger intermediaries (who now seem relatively less expensive) or direct. There is a concern that clients choosing to purchase online without the assistance of an intermediary may not understand the full range of risks to which they are exposed
Quality	Possible slight increase in the quality of services as some intermediaries may need to justify the cost of their services, but this would be considerably limited by the switch into contingent commission that would not be revealed
Variety	Fixed cost of provision likely to hit small intermediaries rather than other types of intermediaries and hence may reduce the variety of intermediaries serving the market Intermediaries who can not accept contingent commission likely to be relatively worse off. Similarly insurers who cannot pay contingent commission will be worse off
Efficiency of competition	Unlikely to improve the overall level of competition due to the switch into (undisclosed) contingent commission. Potential for this to worsen transparency for those few customers who are currently asking for commission information. Will distort competition between small and large intermediaries
Compliance costs	£17.4 million one-off costs and £10.2 million ongoing costs. Some evidence that ongoing costs are higher for smaller intermediaries
Summary	No clear benefits. Small but positive costs Shift to contingent and other forms of remuneration could exacerbate identified market failures and distort competition between small intermediaries and larger intermediaries able to negotiate other forms of remuneration

Source: CRA International

It is interesting to note that the unintended consequences associated with Scenario 1 (such as switching into contingent payments) would also be present if many more clients pro-actively requested information regarding the remuneration of their adviser (as opposed to getting it through mandatory disclosure). It is possible that if clients were encouraged to pro-actively request information, then any changes would arise gradually which may make it easier to make the appropriate system changes. It is unclear whether a gradual move would bring any changes in terms of a movement to contingent commission.

6.3. Scenario 2a: Mandatory disclosure in cash terms to the customer

Scenario 2a attempts to overcome some of the unintended consequences highlighted in scenario 1 by requiring that *all* types of remuneration are disclosed in *cash terms* including any contingent arrangements. Given that the actual value of contingent

80 We were not asked to estimate the direct costs that would fall onto the FSA. This would be required in a detailed CBA.

arrangements may not always be known at the point of sale, the scenario tested was that the *maximum* value of those contingent arrangements would need to be revealed. This would also include work transfer arrangements arranged between the insurer and the intermediary. The description of scenario 2 can be found in Table 14 below.

Table 14: Mandatory disclosure in cash terms to the customer

Issue	Requirement
Who is responsible for the disclosure?	The primary insurance intermediary is responsible for the content, production and provision of information to the commercial customer.
Information requirements	Disclosure of total remuneration receivable by a primary intermediary on a contract of insurance. Two separate figures will be disclosed including: 1) Cash value of any remuneration (excluding fees) known with certainty (as in Scenario 1) 2) Maximum possible value of any other remuneration. Remuneration includes, but is not limited to commission; contingent arrangements (volume and profit share); arrangements for financial products connected to a contract of insurance (premium finance); arrangements for services provided to the insurer of a contract of insurance.
To whom should the information be provided?	The commercial customer.
When should the information be provided?	Before the conclusion of the contract.

Source: CRA International

When there is a profit or volume-based contingent commission agreement between insurer and intermediary this scenario requires disclosure of the maximum potential additional compensation to the intermediary that could arise from this agreement. The disclosure should take two forms:

- The percentage of profit to which the intermediary is entitled on the contract (e.g. 15%); and
- A translation of this figure into cash terms assuming the contract runs claims free (i.e. the maximum profit that can be earned).

Profit based commission depends on the future claims of the book of business (sometimes taking many years to completely identify) and volume based commission depends on how much business is written in the year. By assuming that there are no claims and allocating this across the book of business, it is possible to calculate the maximum contingent commission at the time of the contract.

6.3.1. Market impacts

Scenario 2a covers both standard and contingent commission so avoids the unintended consequences of scenario 1 of a switch towards contingent commission. However, we find that it could still have undesirable unintended consequences regarding the use of profit commission, work transfer, internal controls and the use of chains.

Impact on the use of profit commission

Many intermediaries expressed significant concern about needing to reveal the maximum possible value of contingent arrangements. They indicated that the assumption that there were zero claims made on all policies written under the profit commission arrangement was unrealistic and would create distortions. There are three main concerns regarding the use of the *maximum* for disclosing contingent commission.

First, this would lead to a misleading comparison between standard commission (disclosed as an actual value) and contingent commission (disclosed as a maximum that will almost certainly overstate the actual value).

Second, it could lead clients to negotiate over the contingent payment e.g. by requesting that a proportion of the disclosed contingent commission be rebated to them. Intermediaries were concerned that this would lead to negotiation over a payment that they were not certain to receive. However, it was clear that in practice, intermediaries would attempt to "explain away" the likelihood of receiving the maximum or would reach arrangements with clients whereby a proportion of the contingent payment would be returned once the value of it was known. The latter only seems likely in the case of reasonably long term relationships since the calculation of the value of contingent arrangements can take three years or more depending on the nature of the contract.

Third, disclosing the maximum contingent payment could reduce the number of contracts that use contingent arrangements and this could be inefficient. Section 3.5.4 indicated that there were theoretical and practical advantages to the payment of profit commission in order to align the incentives of intermediaries and insurers. In particular, profit commission can incentivise intermediaries to "make markets" by identifying a customer segment that is not currently being served and to design products to meet their needs. Often this is done through binding authorities which evidence from the compliance cost survey suggests represents around 15-20% of business.

In cases where contingent payments enable the intermediary to provide the client with access to a unique service, it seems reasonable that the intermediary should be able to explain the additional value that the intermediary and the product can bring. However, there is a risk that innovation is reduced because of a fall in profit based commission.

From the insurers' perspective, a reduction in the use of contingent commissions could reduce the number of contracts using binding authorities and reduce sales. Alternatively, binding authorities may continue in the absence of profit commission (or a reduced value from profit commission) but insurers would need to find other ways to check that the business provided by the intermediary would be profitable for the insurer.

This would incur additional auditing costs in order to more closely monitor the book of business provided by an intermediary. This would reduce efficiency since insurers could currently choose to monitor intermediaries in this way, but instead choose to use a binding authority with a profit commission.[81] These increased costs would be expected to be passed on to the client.

While many insurers and intermediaries have binding authorities that do not include a profit commission, these typically arise in the context of a long-term relationship. A reduction in profit commission could therefore impose a barrier to new, and small, intermediaries obtaining binding authorities because the monitoring costs for the insurer means this is no longer worthwhile. There are therefore some legitimate concerns that this would reduce economic efficiency.

Impact on work transfer

The revelation of payments other than the commission paid at the point of sale highlights the role of “work transfer” which occurs when work that would traditionally have been seen as part of the underwriting activity is passed over to the intermediary to be done on behalf of the insurer. Revealing these payments will make intermediaries undertaking work transfer appear expensive.

There are a number of insurers who are outsourcing some of the underwriting functions to the intermediary because they believe that the intermediary is able to offer a better overall service either in terms of doing particular functions more cheaply or in terms of having better servicing of the end client. However, some insurers believe that payments for work transfer simply reflect intermediaries exploiting their bargaining position and receiving a higher payment since there is not necessarily a great deal of work that is actually transferred.

The clear difficulty for the scenario is that the disclosure rule suggested in this scenario can not differentiate between the payments that are for genuine work transfer and those that are simply ways to pay the intermediary more. Imposing this scenario is therefore likely to penalise genuine work transfer and result in activities moving back to the insurer irrespective of whether the work would be most efficiently done by the intermediary.

Internal controls

A concern raised about this scenario relates to the information regarding contingent remuneration within an intermediary company. Many intermediary firms were aware of the potential conflict of interest introduced by profit or volume based commission and had introduced controls such that the structure of these arrangements was only known at management level. Disclosing this information could make individual intermediaries more aware of these arrangements and hence more likely to be influenced by them.

81 Insurers will undertake monitoring and examine regular reports from those with whom they have a binding authority at present, but would need to do more monitoring in the absence of profit commission to ensure that the book of business was profitable for them.

Impact on chains

Of most note in this scenario is the unintended consequence that might transpire in order to get around the disclosure requirements. Since the scenario requires disclosure only by the primary intermediary of the remuneration earned by the primary intermediary, this will benefit primary intermediaries who are already using chains. These intermediaries will look less expensive compared to intermediaries who are undertaking all of the activities themselves.

Therefore it is possible that intermediaries create chains in order to reduce the amount of remuneration being disclosed. Indeed, this reaction was suggested in both the insurer and the intermediary workshops. Simply using a fully owned subsidiary would not get around the regulations since current rules require commissioned earned by any associates to be disclosed. Instead, a transaction would be required between two distinct companies.

It is possible however, that two intermediaries would reach an “implicit” agreement where the primary business that they have would be passed through the other intermediary who would act as a conduit. The majority of the commission would sit with the intermediary acting as the wholesale intermediary leaving little commission being earned by the primary intermediary and therefore little commission disclosed to the client. This could represent a reciprocal arrangement between intermediaries. Alternatively, the wholesale intermediary may look for ways that they could make a payment for some other “service” provided by the primary intermediary. This would clearly depend on the detail of the rules set out by the FSA.

Whether firms would set up chains would depend on the cost of doing so. However, since a large number of intermediaries are simultaneously acting as both primary and wholesale intermediaries for different clients, and since intermediaries commonly have strong relationship with other intermediaries for particular types of business, this may not require too much reorganisation to their businesses. Fixed costs associated to setting up these chains may prevent some, especially small, intermediaries from doing so, but this appears to be the only constraint acting to prevent such a structural reorganisation from arising.

If such chains are set up, this would once again frustrate the aims of the regulation since the amount of commission that would be left to disclose to the primary intermediary would only represent a small proportion of what they were actually receiving (in much the same way as failing to disclose contingent arrangements in scenario 1).

6.3.2. Compliance costs

The compliance costs for this scenario are set out in Table 15. As expected the one-off costs of these are higher than reported in Scenario 1 due to the need to undertake more significant changes to systems.

Table 15: Compliance costs for scenario 2a

	One-off	Ongoing
Incremental compliance cost (£ millions)	23.3	13.2
As a % of Gross Written Premium	0.13%	0.07%

Source: CRA International

Looking at the composition of these costs, the main difference to scenario 1 is increased systems costs required to estimate the value of the contingent commission arrangements.

6.3.3. Summary of scenario 2a

In summary, scenario 2a does not appear to have any clear benefits because of the ability to "get around" the regulations. In particular, the ability to develop chains in order to reduce the value of commission that would be revealed would reduce the effectiveness of the regulations. Given the lack of clear benefits these would be likely to be outweighed by the positive costs.

Table 16: Summary of impacts in scenario 2a

Component of CBA	Summary
Quantity of services	Could be a reduction in specialist insurance and in intermediation due to a decrease in profit commission reducing binding authorities
Quality	Possible slight increase in the quality of services as intermediaries may need to justify the full cost of their services, but this would be considerably limited by intermediaries forming chains in order to get around the regulation
Variety	Intermediaries who are "making markets" through profit commission paid on binding authorities are likely to be most hit in this scenario and therefore there is a danger that some of the more esoteric or specialised risks that have been covered in the past may fail to be covered or that innovation to attempt to reach new customer segments will be curtailed
Efficiency of competition	Some improvement in efficiency where intermediaries are unable to form chains to get around the regulations, but potential for efficiency to decline if chains are introduced simply to avoid regulation as this would add additional costs.
Compliance costs	£23.3 million one-off costs and £13.2 million ongoing costs. Some evidence that ongoing costs are higher for smaller intermediaries.
Summary	No clear benefits. Small but positive costs Could encourage the development of chains of intermediaries in order to get around the regulation

Source: CRA International

6.4. Scenario 2b: Mandatory disclosure in cash terms to the customer and insurer

In comparison to scenario 2a, this scenario assumes that information regarding the remuneration received by the primary intermediary will not only be disclosed to the client, but would also be disclosed to the insurer. The description of scenario 2b can be found in Table 17 below.

Table 17: Mandatory disclosure in cash terms to the customer and insurer

Issue	Requirement
Who is responsible for the disclosure?	The insurance intermediary is responsible for the content, production and provision of information to the commercial customer. The non-primary intermediary(s) is responsible for facilitating the transmission of information
Information requirements	Disclosure of total remuneration receivable by a primary intermediary on a contract of insurance. Two separate figures will be disclosed including: 1) Cash value of any remuneration (excluding fees) known with certainty (as in Scenario 1) 2) Maximum possible value of any other remuneration. Remuneration includes, but is not limited to commission; contingent arrangements (volume and profit share); arrangements for financial products connected to a contract of insurance (premium finance); arrangements for services provided to the insurer of a contract of insurance.
To whom should the information be provided?	The commercial customer The primary intermediary must also disclose own remuneration to the insurer.
When should the information be provided?	Before the conclusion of the contract.

Source: CRA International

This scenario would only involve providing *additional* information to the insurer where there is a chain of intermediaries involved in the transaction (since where there is only one primary intermediary involved, the insurer would already know the commission that they pay that particular intermediary). In particular, it involves informing the insurer about the commercial terms within a chain of intermediaries.[82] Any wholesale intermediaries would be required to facilitate the communication of information from the primary intermediary to the insurer – thereby communicating details of the primary intermediary's remuneration to other intermediaries in the chain who have to facilitate this information.[83]

82 Note that the scenario does not involve information on each and every intermediary in the chain being disclosed to the insurer, but only the information on the remuneration received by the primary intermediary.

83 Where there are only two intermediaries, the wholesale intermediary would already know the remuneration of the primary intermediary and so this only provides *additional* information to the wholesale intermediary where there are more than two intermediaries in the chain.

6.4.1. Market impacts

The disclosure of information to the client in this scenario is the same as scenario 2a, so any additional benefit must arise from disclosure to the insurer. Based on evidence from interviews, insurers value information about how remuneration is divided between primary and wholesale intermediaries in two circumstances:

- Where the intermediary is being delegated responsibility on behalf of the insurer and the insurer's reputation is at risk; and

- When the insurer could gain competitive intelligence by understanding how much of the commission the wholesale intermediary passes to the primary intermediary.

The first argument seems weak since insurers indicated that they would *already* ask for information on the split between wholesale and primary intermediaries where they offer a binding authority if they are concerned to ensure that both sets of intermediaries are operating in a sustainable manner. If they did not receive the information insurers noted that they have the option of not offering the binding authority to those intermediaries.

The second argument is questionable from a competition and efficiency perspective. The main use of this information by insurers would be to dis-intermediate the wholesale intermediary and to go straight to the primary intermediary. This could enable the insurer to raise the commission to the primary intermediary yet lower the cost to the client. However, there are two reasons to be sceptical that this would occur:

- The insurer can *already* choose to offer higher commission or improved prices directly to the primary intermediary. Therefore if competition is effective, this additional information would be unnecessary; if competition is not effective, it is unlikely that the benefit will be passed on to the client.

- Dis-intermediating wholesale intermediaries may remove a cost but also removes a useful economic activity of identifying primary intermediaries and their clients to whom certain types of insurance can be sold. Wholesale intermediaries will not search for, and actively market to, primary intermediaries unless they can be appropriately remunerated for this - which they would not be if insurers begin direct relationships with primary intermediaries. To the extent that wholesale intermediaries are best placed to undertake this activity, it would be economically inefficient if they no longer performed this activity and could result in customers receiving lower quality or a smaller choice of products.

Insurers can already compete by going direct to primary intermediaries. If insurers are more efficient than wholesale intermediaries at finding these primary intermediaries then competition will result in dis-intermediation. Indeed, this process is already underway with insurers using regional agents to distribute their policies rather than using wholesale intermediaries. This suggests that where more efficient distribution models can arise, insurers are already taking steps to develop such models. A regulation of the form suggested would therefore be expected to accelerate this trend (potentially inefficiently) rather than rely on market forces.

We have competition concerns regarding this scenario. In particular, this scenario envisages revealing to the insurer commercial terms made between the wholesale intermediary and the primary intermediary. When the insurer is also dealing direct with the primary intermediary this would give the insurer an unfair advantage compared to the wholesale intermediary since the insurer would know the level of commission agreed by the wholesale intermediary on any given policy and could later exploit that information.

6.4.2. Compliance costs

The compliance costs associated with this scenario are higher than those in 2a because of the obligation of the primary intermediary to provide information regarding their remuneration to the insurer.

The size of costs would be expected to depend on the frequency with which chains are used and where disclosure to the insurer is not already taking place. It has not been possible to gather detailed data on the percentage of business written through chains in the UK. However, it is common both to have a small primary intermediary using a wholesale intermediary to access the Lloyd's market as well as having a chain of three intermediaries where the wholesale intermediary uses a product provided through a binding authority operated by another wholesale intermediary.

In terms of the costs incurred by insurers, it has been assumed that there are no costs since they do not have to provide any information to the clients. They have the opportunity to use the information that is disclosed to them although not the obligation and hence if they use the information it will be because they consider this to be of benefit to them and therefore it would not be appropriate to consider this as a cost.

Table 18: Compliance costs for scenario 2b

	One-off	Ongoing
Incremental compliance cost (£ millions)	32.2	14.2
As a % of Gross Written Premium	0.18%	0.08%

Source: CRA International

The compliance cost survey also indicates that ongoing costs are higher for smaller intermediaries.

6.4.3. Summary of scenario 2b

In summary, compared to scenario 2a, scenario 2b does not appear to have any clear benefits because of the potential distortions from providing commercial information to insurers. In addition, this may reduce the efforts of wholesale intermediaries in identifying new market opportunities. Costs are also higher for this scenario compared to 2a.

Table 19: Summary of impacts in scenario 2b

Component of CBA	Summary
Quantity of services	Same as 2a
Quality	Possible that current market activities undertaken by wholesale intermediaries to identify primary intermediaries are reduced with the result that primary intermediaries offer lower quality products to their clients
Variety	Same as 2a but choice offered to primary intermediary could diminish
Efficiency of competition	Could increase trend to dis-intermediation but if this is economically efficient this will occur over time any way
Compliance costs	Increased relative to Scenario 2a to £32 million one-off costs and £14 million ongoing costs. Some evidence that ongoing costs are higher for smaller intermediaries.
Summary	The provision of information to the insurer has the potential to distort competition. Where this information is required by the insurer it can already be requested by the insurer and it would appear that this commonly occurs (although not always).

Source: CRA International

6.5. SCENARIO 3A: MANDATORY DISCLOSURE OF TOTAL REMUNERATION PAYABLE TO INTERMEDIARIES THROUGHOUT THE CHAIN – PRE SALE

In this scenario, in addition to the primary intermediary disclosing their remuneration, the *insurer* would provide information on *total* commission paid along the chain. In scenario 3a this occurs pre sale (in scenario 3b the information is disclosed post sale). The value disclosed would represent the maximum commission payable including contingent payments as well as standard commission. The description of scenario 3a can be found in Table 20 below.

Table 20: Mandatory disclosure of total remuneration payable to intermediaries throughout the chain – Pre sale

Issue	Requirement
Who is responsible for the disclosure?	The primary intermediary is responsible for providing all information to the commercial customer. The primary intermediary is responsible for the content and production of information relating to its own remuneration. The insurer is responsible for the content and production of information relating to total remuneration payable to all intermediaries throughout the chain. Non-Primary intermediaries are responsible for facilitating the transmission of information.
Information requirements	Disclosure of total remuneration receivable by a primary intermediary on a contract of insurance. The primary intermediary is responsible for the content and production of this information. Two separate figures will be disclosed including: 1) Cash value of any remuneration (excluding fees) known with certainty

	2) Maximum possible value of any other remuneration. Remuneration includes, but is not limited to: commission; contingent arrangements (volume and profit share); arrangements for financial products connected to a contract of insurance (premium finance); arrangements for services provided to the insurer of a contract of insurance. Disclosure of the total remuneration payable to all intermediaries throughout the chain (including the primary intermediary). The insurer is responsible for the content and production of this information. Two separate figures will be disclosed: 1) Cash value of any remuneration (excluding fees paid by the customer) known with certainty (as in Scenario 1) 2) Maximum possible value of any other remuneration. Remuneration includes, but is not limited to: commission; contingent arrangements (volume and profit share); arrangements for financial products connected to a contract of insurance (premium finance); arrangements for services provided to the insurer of a contract of insurance. NB: This is a requirement to disclose the total not the split between each and every intermediary along the chain
To whom should the information be provided?	The commercial customer. Any intermediary facilitating the transmission of commission information to the commercial customer (through the chain).
When should the information be provided?	Before the conclusion of the contract.

Source: CRA International

6.5.1. Market impacts

This scenario will provide additional information to the client when there is a chain of intermediaries. For example this could occur when a primary intermediary uses one or more wholesale intermediaries such as using a Lloyd's broker to access the Lloyd's market or where a primary intermediary uses a managing general agent of an insurer.

The advantage of this scenario is that the full amount of commission is disclosed along the chain with the result that:

- it is not possible for intermediaries to create a chain in order to prevent commission being disclosed as in scenarios 1 and 2 (a and b); and

- it makes the client aware that there is more than one intermediary in the chain.

Since this scenario involves the total amount of remuneration being disclosed, it is likely to have the largest impact in terms of clients placing competitive restraint on intermediaries or choosing to purchase direct. In addition, revelation of the total remuneration paid in a chain means that vertically integrated intermediaries would not be disadvantaged compared to non-integrated intermediaries (as was the case in Scenarios 1 and 2).

The benefits from this scenario compared to scenario 2a depend on how common it is to have chains within the UK and the degree to which clients are already aware that their intermediary is using the services of another intermediary. As noted in the previous scenario, it has not been possible to gather accurate information on this. However, interview evidence indicated the use of chains is still common although it is diminishing in the UK as there has been a trend to shorter chains and intermediaries re-structuring their businesses. For example:

- Many wholesale intermediaries are imposing their own rules such that they are only willing to operate directly with the primary intermediary; and
- Consolidators have integrated Lloyd's brokers into their business model making it unnecessary to go outside of the company.

Evidence from our client survey found that only 2% of micro-enterprises and SME clients were aware that another intermediary was being used (although we were not able to determine if a chain was actually being used). Large clients, commonly paying on a fee basis, will be in direct communication with the insurers and would be aware if a wholesale intermediary was involved (although if they are using an international intermediary this is unlikely to be the case). It is amongst middle size clients where there are most concerns regarding low awareness of chains.

The impact of disclosing the full commission along the chain could therefore result in clients going direct to a wholesale intermediary or the client choosing to go direct to the insurer instead of using an intermediary at all. This could represent a benefit if chains are currently inefficient or it could reduce the quality of cover where the intermediaries are providing a valuable service. However, these effects will be partly mitigated because:

- Many wholesale intermediaries do not wish to deal with, and do not have the infrastructure to deal with, small commercial clients and are therefore likely to tell clients to return to their primary intermediary for the arrangement of their insurance; and
- Access to Lloyd's is only possible through Lloyd's brokers. Clients are not able to access the Lloyd's market directly and thus would need to continue using an intermediary since the same product may not be available from those insurers who would deal direct with clients.

In addition, the primary intermediary could justify the need for the wholesale intermediary. In some cases, intermediaries were confident that clients would accept that using a wholesale intermediary gave them access to a particular facility that they could neither access directly themselves or through another intermediary. In other cases, intermediaries accepted that clients would put pressure on wholesale chains to justify the services they provided and that this could lead to disintermediation of some intermediaries in the chain.

As this scenario covers the full chain and all forms of commission paid along the chain, it is not possible to manipulate the way that commission is presented or the structure of the primary-wholesale intermediary relationship in order to "cover up" the intermediary's remuneration. The ability to exploit loopholes in this scenario is therefore substantially reduced compared to either Scenario 1 or 2.

However, there are issues with the way the information is delivered to the client and the cost of disclosing pre sale. For example, the insurer does not have a direct relationship with the client and therefore does not have any direct communication with them during the pre sale process and so the insurer would need to provide this information to the primary intermediary. This will impose a cost on the insurer, any wholesale intermediary and the primary intermediary.

In addition, during the negotiation process intermediaries may be getting quotes from a number of insurers and for a number of different products. Each of these insurers would need to reveal not only standard commission but the maximum potential compensation from contingent arrangements with the intermediary. This would involve a considerable amount of information being presented which clients may wish to be consolidated. This could encourage intermediaries to:

- go to a single insurer, lowering the quality of the package although interviews with intermediaries revealed that the differences between the offerings of different insurers make this unlikely to occur in reality; and
- ask the insurer to delegate document production to the intermediary so that this can be produced pre sale without large transaction costs. The advantage of this would be that the intermediary could make a disclosure that was “client centric”.

One possible impact of pre sale disclosure is to slow down the process of being able to obtain cover because of a need to provide the disclosure documents to the client in advance of the parties being bound. Intermediaries indicated that some clients give them the ability to bind subject to certain conditions (e.g. the premium being below a certain level) which means that placement can occur in a very short period of time. However, if intermediaries are required to disclose the commission arrangements to the client, this will require an extra iteration with the result that this could slow down the renewal process.

Transferring work from the insurer to the intermediary is also problematic in this scenario. To the extent that clients choose their intermediary on the basis of comparing the disclosed commission amount, this would make intermediaries undertaking work transfer appear expensive. The most extreme case of this is when the intermediary is acting as an MGA. If these payments are included in the disclosed commission (as assumed in this scenario), this could make MGAs look expensive. Therefore we might expect this scenario to dampen the trend to setting up MGAs. Insurers and intermediaries believe that this would reduce efficiency in some cases, as the MGA is better placed to undertake these activities than the insurer.

6.5.2. Compliance costs

In terms of the compliance costs of this scenario, unlike Scenarios 1 and 2 this now imposes a cost on insurers as they would need to change their quote documents to include the full amount of commission paid along the chain. From the interviews undertaken for this project, this will have a very different impact on the company market compared to the Lloyd's market where firms operating in the latter believe that the cost would be significantly less than firms operating in the former. This reflects the fact that Lloyd's brokers are typically already responsible for the cost of documentation.

In the company market the systems cost in generating gross and net premium would require significant investment. This is because there are a number of large insurers who have separate systems for the purpose of determining gross premiums and providing information for clients, compared to systems associated to the payment of intermediaries. This scenario would require these systems to be combined, hence the large incremental costs.

Table 21: Compliance costs for scenario 3a

		One-off	Ongoing
Intermediary	Incremental compliance cost (£ millions)	48.0	18.1
	As a % of Gross Written Premium	0.27%	0.10%
Insurer	Incremental compliance cost (£ millions)	39.0	16.3
	As a % of Gross Written Premium	0.22%	0.09%
Total	Incremental compliance cost (£ millions)	87.0	34.4
	As a % of Gross Written Premium	0.49%	0.19%

Source: CRA International

6.5.3. Summary of scenario 3a

Scenario 3 will result in disclosure of the full remuneration of intermediaries along the chain. This reduces the potential for the unintended consequences observed in the other scenarios.

Table 22: Summary of impacts in scenario 3a

Component of CBA	Summary
Quantity of services	The cost of commission will look higher compared to scenarios 1 and 2 and potentially this would cause the greatest switch to direct
Quality	Reduced incentives to use wholesale intermediaries or chains could reduce quality of cover Disincentive to develop MGA and work transfer could mean that client service is diminished
Variety	Effect across market, so impact on different types of intermediaries is not as polarised Could reduce MGAs

Efficiency of competition	Full disclosure of cost of commission and greatest competitive pressure imposed across chain Pressure imposed on wholesale intermediary to justify value and potential to reduce chains where these are inefficient Introduces time delay in renewals
Compliance costs	£87 million one-off costs and £34 million ongoing costs.
Summary	Most effective form of disclosing commission but potential effects on work transfer Significant costs and benefits. The net effect is estimated in section 6.8 below

Source: CRA International

Since there are no unintended consequences in this scenario that lead to the aims of the regulation being frustrated, and since there appear to be some benefits from this form of mandatory disclosure, it is necessary to consider whether the magnitude of benefits is likely to be greater than the compliance costs. This is considered in section 6.8 below.

6.6. Scenario 3b: Mandatory disclosure of total remuneration payable to intermediaries throughout the chain - post sale for insurer

The only difference between scenario 3a and scenario 3b is the time at which the information is disclosed. In scenario 3b the information on the total commission along the chain is disclosed after the end of the sales process although the commission earned by the client facing intermediary would still be disclosed pre sale. The description of scenario 3b can be found in Table 23 below.

Table 23: Mandatory disclosure of total remuneration payable to intermediaries throughout the chain – Post sale for insurer

Issue	Requirement
Who is responsible for the disclosure?	The primary intermediary is responsible for providing all information to the commercial customer. The primary intermediary is responsible for the content and production of information relating to own remuneration. The insurer is responsible for the content and production of information relating to total remuneration payable to all intermediaries throughout the chain. Non-Primary intermediaries are responsible for facilitating the transmission of information
Information requirements	Disclosure of total remuneration receivable by a primary intermediary on a contract of insurance. To be produced by the primary intermediary. Two separate figures will be disclosed including: 1) Cash value of any remuneration (excluding fees) known with certainty 2) Maximum possible value of any other remuneration. Remuneration includes, but is not limited to commission; contingent arrangements (volume and profit share); arrangements for financial products connected to a

	contract of insurance (premium finance); arrangements for services provided to the insurer of a contract of insurance. Disclosure of the total remuneration payable to all intermediaries throughout the chain (including the primary intermediary). To be produced by the insurer. Two separate figures will be disclosed including: 1) Cash value of any remuneration (excluding fees) known with certainty (as in Scenario 1) 2) Maximum possible value of any other remuneration. Remuneration includes, but is not limited to: commission; contingent arrangements (volume and profit share); arrangements for financial products connected to a contract of insurance (premium finance); arrangements for services provided to the insurer of a contract of insurance. NB: This is a requirement to disclose the total not the split between each and every intermediary along the chain
To whom should the information be provided?	The commercial customer. Any intermediary facilitating the transmission of commission information to the commercial customer (through the chain).
When should the information be provided?	Total Primary intermediary remuneration = pre sale Total remuneration paid/payable to all intermediaries throughout the chain = Post sale (at or before disclosure of the policy documents).
Scope	The requirement to disclose primary intermediary remuneration holds only when all of the following criteria apply: the primary intermediary in contact with the customer is FSA authorised and the commercial customer is habitually resident in the EEA and for general insurance contracts, the risk is located in the EEA Disclosure of total remuneration payable throughout the chain is mandatory when all of the following apply: the intermediary in contact with the customer is FSA authorised; and the insurance undertaking is FSA authorised; and the commercial customer is habitually resident in the EEA; and for general insurance contracts, the risk is located in the EEA

Source: CRA International

6.6.1. Market impacts

In this scenario it will be possible to disclose insurer information on total commission in the policy document provided to the client post sale.

As the intermediary will not need to disclose the insurer's information pre sale, they will not need to co-ordinate with the insurer during the negotiation. This will eliminate the difficulty for the intermediary of coordinating insurer responses pre sale.

The most significant difference in the market outcome associated to scenario 3b compared to scenario 3a is the likely client response. This project has not directly tested the difference between pre sale disclosure and post sale disclosure with clients.[84]

84 We have interpreted the client responses discussed in section 6.1 as being due to pre sale disclosure

Insurers and intermediaries were sceptical that information provided in the policy document post sale would be used by clients. This is because intermediaries believe that clients do not commonly read policy documents. Furthermore, unless there were prescriptive rules regarding the presentation of information intermediaries expected that such information would be hidden in the depths of the policy document.

However, commercial insurance is purchased annually and information provided in the policy documents may influence the purchase process in the subsequent year. Here we note that if the post sale information fed into the purchase process in the subsequent year, we would expect clients to ask for the information to be provided pre sale in the following year, so that they could use this information in their negotiation process. In this case, introducing Scenario 3b would in practice result in the market migrating towards Scenario 3a, which would eliminate the need for post sale disclosure.

Alternatively, if post sale disclosure does not lead clients to request information pre sale in subsequent years, this would suggest that clients were not using the information and therefore that benefits would be very small.

For these reasons, Scenario 3a is superior to Scenario 3b from the perspective of bringing benefits. If clients are less likely to use post sale information than pre sale information, all of the market impacts associated to this scenario will be smaller than those in scenario 3a.

6.6.2. Compliance costs

Looking at the compliance costs we find that the costs of post sale disclosure (scenario 3b) are higher than pre sale disclosure (scenario 3a). This may be because some insurers assumed that they would still be required to disclose pre sale even if the rules required only post sale disclosure.

Table 24: Compliance costs for scenario 3b

		One-off	**Ongoing**
Intermediary	Incremental compliance cost (£ millions)	48.0	18.1
	As a % of Gross Written Premium	0.27%	0.10%
Insurer	Incremental compliance cost (£ millions)	42.0	18.2
	As a % of Gross Written Premium	0.24%	0.10%
Total	Incremental compliance cost (£ millions)	90.0	36.3
	As a % of Gross Written Premium	0.50%	0.20%

Source: CRA International

As in the previous scenario we would see compliance costs being imposed onto primary intermediaries, wholesale intermediaries and insurers (although the cost falling on Lloyd's syndicates would appear small).

6.6.3. Summary of scenario 3b

The compliance survey finds that the costs of post sale disclosure are higher than the costs of pre sale disclosure. In addition, there is scepticism that post sale disclosure would be useful to clients. Therefore Scenario 3b is clearly inferior compared to scenario 3a.

Table 25: Summary of impacts in scenario 3b

Component of CBA	Summary
Quantity of services	Less likely to be used by clients so smaller impact on the demand for intermediary services than scenario 3a
Quality	Less likely to be used by clients so smaller impact on the demand for intermediary services than scenario 3a
Variety	Less likely to be used by clients so smaller impact on the demand for intermediary services than scenario 3a
Efficiency of competition	Less likely to delay insurance being completed as can be delivered post sale but if effective would encourage pre sale
Compliance costs	£90 million one-off costs and £36 million ongoing costs. Introduces duplicate costs
Summary	Possible benefits. Significant costs (greater than 3a) This scenario is clearly inferior to scenario 3a

Source: CRA International

6.7. Scenario 4: Disclosure of commission equivalent by direct insurers

This scenario applies to insurers dealing directly with commercial clients on a non-intermediated basis. In this case, the direct writer would need to disclose a commission equivalent. We have assumed that this scenario would only occur in addition to mandatory commission disclosure and hence this should not be considered as a standalone scenario. The description of Scenario 4 can be found in Table 26 below.

Table 26: Disclosure of Commission Equivalent by direct insurers

Issue	Requirement
Who is responsible for the disclosure?	The insurer is responsible for the content, production and provision of information to the commercial customer.
Information requirements	Disclosure of a commission equivalent on non-intermediated business. Determined as the maximum commission equivalent payable in cash terms.
To whom should the information be provided?	The commercial customer.
When should the information be provided?	Before the conclusion of the contract.

Scope	The requirement to disclose a commission equivalent holds only when all of the following criteria apply: the insurance undertaking is FSA authorised and the customer is habitually resident in the EEA and for general insurance contracts, the risk is located in the EEA

Source: CRA International

6.7.1. Market impacts

The argument that has been made in favour of commission equivalence is that the absence of disclosure would lead to a distortion between intermediaries and direct writers. It is argued that there would be an un-level playing field between intermediaries and direct insurers if intermediaries serving this segment must disclose commission while direct insurers have no similar form of disclosure (as assumed in Scenario 1, 2 and 3 above). As intermediaries would need to disclose an amount for their services, clients may choose to use the direct channel where there is no equivalent cost. It was argued that this would introduce a regulatory failure into the other scenarios and that, in addition, commission equivalent was required to solve this.

Based on the evidence in chapter 4, the direct channel only represents a viable alternative for the smallest customers where around 50% purchase direct and 60% use an intermediary (indicating that some use both for different types of insurance). For many intermediaries, therefore, the direct channel would only represent a likely competitor for a small proportion of their business.

This both indicates that any regulatory failure introduced by commission disclosure on intermediaries would be small, and also indicates that any competitive effects between the two types of channels is also likely to be reasonably small.

Indeed, some intermediaries already view this segment of the market as unattractive because these clients do not value their primary attribute, the provision of advice, but rather are only interested in price. Since these intermediaries did not want to compete merely on price this has lead to some intermediaries withdrawing from this segment or to some intermediaries setting up low cost distribution arms as a method of competing with the direct writers.

The direct channel is increasing and insurers are actively seeking to expand their offering. However, both insurers and intermediaries agree that this will be limited to very small companies wishing to purchase simple products.

As noted in scenario 1, some clients state commission disclosure would cause them to consider approaching the insurer directly. However, since the direct market is expected to increase, commission disclosure would simply accelerate a trend that is occurring anyway. Moreover, the customers who choose to go direct are those focusing on gross written premium and it seems unlikely that commission equivalent would be useful for these customers or would prevent them from switching were the cost of intermediation to push them to consider the direct channel.

One of the most difficult elements of this scenario is what commission equivalent would entail. A number of both insurers and intermediaries questioned the value of disclosing a commission equivalent figure since they did not believe that disclosing marketing and acquisition costs in the direct channel could be considered equivalent to commission income. In addition, both insurers and intermediaries noted that providing an equivalent number would suggest to clients they are getting an equivalent service which could be mis-leading. Intermediaries argued that this could in fact lead commission equivalent to be detrimental to intermediaries; while direct writers argued that they were not providing the same service as intermediaries.

6.7.2. Compliance costs

Although compliance costs were requested from 5 direct writers, we did not receive sufficient quantitative data on the cost of this scenario to present results. However, based on the data provided, it appears that the cost as a percentage of gross written premiums is of a similar or greater magnitude to that of mandatory commission disclosure for intermediaries.

6.7.3. Summary of scenario 4

Based on the assessment above, it appears unlikely that any regulatory failure would result from a lack of disclosure of commission equivalent and therefore that any benefits from such disclosure would be small.

Table 27: Summary of impacts in scenario 4

Component of CBA	Summary
Quantity of services	Unlikely to have a significant impact since most clients considering the direct channel focus on a comparison of GWP
Quality	Little impact due to separation of the markets
Variety	Little impact due to separation of the markets
Efficiency of competition	Little effect as most clients using the direct channel focus on gross written premium
Compliance costs	Limited data provided suggests similar or greater magnitude to mandatory commission disclosure
Summary	Only relevant if mandatory commission disclosure introduced. Based on differences in clients and difficulty in disclosing a meaningful measure this is unlikely to bring net benefits

Source: CRA International

6.8. Summary and Conclusion of Cost Benefit Analysis

This chapter has demonstrated that there are significant undesirable unintended consequences with all the mandatory commission scenarios except for Scenario 3a, that is, pre sale disclosure of total remuneration. We therefore only examine in detail whether the benefits could exceed the costs for this scenario.

Quantification of the costs and benefits of Scenario 3a

As set out in section 6.5, the compliance costs associated with scenario 3a, when scaled up to the market, are estimated at approximately £87 million of one-off costs for both insurers and intermediaries and £34 million of ongoing costs. When we combine the one-off costs with the ongoing costs we find that these costs would represent around £51 million per year or 0.3% of gross written premiums.[85]

These costs fall roughly equally across insurers and intermediaries but these costs do not fall evenly across different types of intermediary. Large international intermediaries have a relatively low cost of complying with the scenario as they: already disclose commission; do not accept contingent commission (and so would not have to disclose a maximum); and are often acting as the only intermediary in a chain. Hence smaller intermediary firms face proportionately larger compliance costs than larger international intermediaries.

The important question is whether these costs are likely to be exceeded by benefits from reducing market failures. The main benefit from disclosure would be enhanced competition amongst intermediaries leading to a reduction in remuneration levels. As the reduction in commission is prompted by customers reacting to commission disclosure, it seems reasonable to assume that any reduction in commission will then be passed on in terms of lower gross premiums.

When assessing the benefits from mandatory commission disclosure, it is important to note that benefits can only arise:

- In the part of the market where disclosure does not *already* occur;[86]
- In the part of the market where market failures associated to a lack of commission disclosure have been identified; and
- For those customers who act on any information provided.[87]

In Table 2 below we show that commissions would need to fall by between 29% and 36% within the affected segment of the market in order for benefits to equal compliance costs.

85 This is based on spreading the one-off costs over five years and adding this to the ongoing costs (0.5%/5+0.2%).

86 As is common in CBAs, we have not taken into account whether there is non-compliance with the existing regime.

87 Given the nature of the relationship between intermediaries and their clients, it seems likely that disclosure would only affect those clients acting on the information rather than have a market wide impact on the level of commission or premium.

Table 28: Quantification

	Calculation
Total compliance costs [a]	£51 million
Total GWP of UK commercial insurance business [b]	£17.7 billion
Proportion of GWP in the middle segment (where market failures have been identified) [c]	52%
Proportion of middle segment customers who do not already receive commission disclosure [d]	40-50%
Proportion of customers expected to act on commission information [e]	19%
GWP of middle segment customers who could benefit from commission information [f] = [b]*[c]*[d]*[e]	£700-875 million
Average remuneration [g]	20%
Remuneration in affected segment [h]=[f]*[g]	£140-175 million
Necessary fall in remuneration from commission disclosure among those customers who would be affected [j] =[a]/[h]	29%-36%

Source: CRA International

However, it is not clear from the evidence that mandatory disclosure would achieve the required impact on commission rates. Evidence from intermediaries regarding the likely impact on commission suggests that a reduction of 10% within *this segment* of clients is more likely.[88]

Furthermore, our calculations have not taken into account a number of potential costs:

- Any loss of service provided to the client, either by their intermediary in response to a decline in the price of their services or resulting from clients moving from the advised to the direct channel;
- A reduction in the use of profit commission, caused by the disclosure of the maximum value of contingent payments could increase the cost of monitoring intermediaries. This could also reduce the incentives of intermediaries to innovate by working with insurers to create specialist and niche products; and
- This scenario might distort the decision regarding undertaking work transfer, as this would result in a higher level of disclosed commission, potentially reducing the service to the client and leading to a reduction in efficiency.

88 It is also possible to examine this result at the level of the whole market rather than only the affected segment. Intermediaries estimated that the impact across the whole market would be a reduction of less than 0.5% of remuneration. With an average rate of remuneration of 20% of premiums, this would translate into a reduction of less than 0.1% of GWP. This is clearly less than the estimate of compliance costs of 0.3% of GWP.

The compliance costs of mandatory commission disclosure have been estimated to be around £51 million and it is not clear from the evidence that mandatory disclosure would achieve a reduction in commission rates necessary to bring about benefits of a similar level. In addition, there are a number of detrimental market impacts that could arise leading to a reduction in the quality and variety of products available for clients. For these reasons we conclude that, based on the evidence gathered for this report, the cost of mandatory commission disclosure would outweigh the benefits.

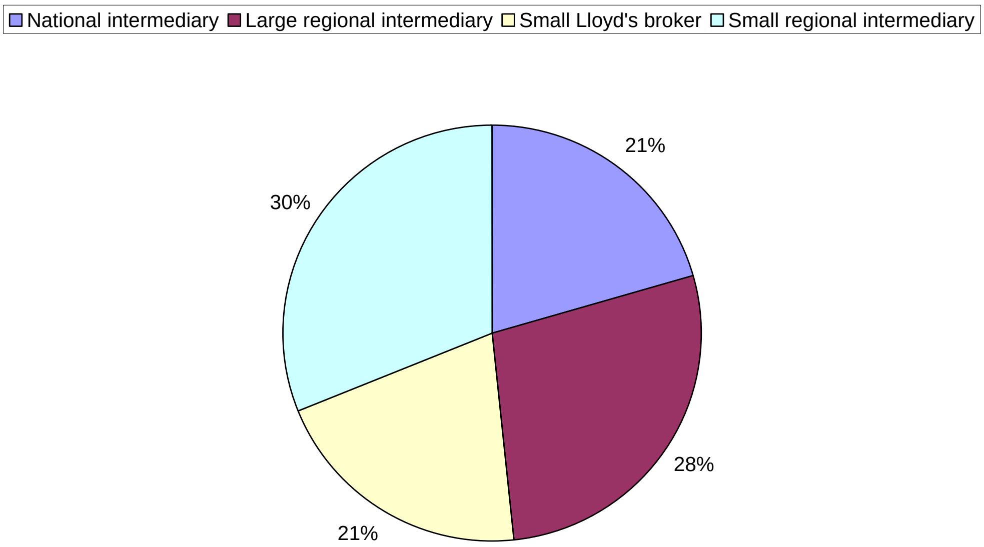
APPENDIX A: COMPLIANCE COST SURVEY

CRA International sent out a compliance cost survey to a cross-section of intermediaries and insurers to help estimate the costs incurred through compliance with mandatory commission disclosure. This survey was sent out to 58 intermediaries and 43 insurers. We received responses from 35 intermediaries and 22 insurers.

The breakdown of the surveys into the various sub-groups is shown in Figure 23 and Figure 24 in terms of the surveys received. The responses varied in depth from the majority of respondents who completed the survey in its entirety to a small number who only gave minimal information.

In the case of intermediaries, the response rate across all categories was very similar and so the breakdown shown in Figure 23 is almost identical to the breakdown of the surveys sent out.

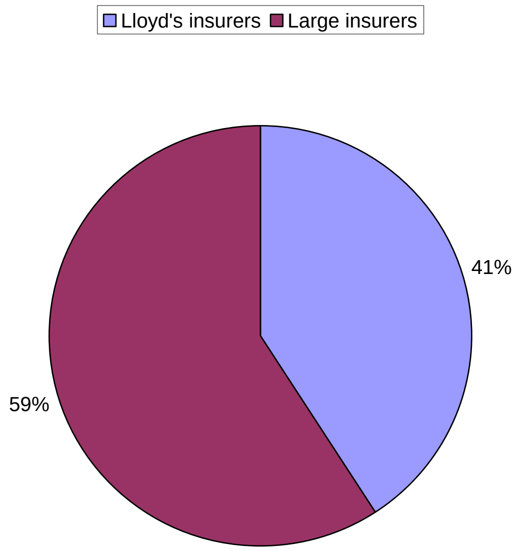
Figure 23: Breakdown of intermediary compliance cost survey responses



Source: CRA International

In the case of insurers, 45% of the surveys were sent to large insurers and 55% were sent to Lloyd’s insurers. The response rate of the Lloyd’s insurers was lower than that of the large insurers and hence the breakdown of the respondents shows a greater proportion of responses are from large insurers is as shown in Figure 24.

Figure 24: Breakdown of insurer compliance cost survey responses



Source: CRA International

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