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Due diligence in the selection of insurers

As trusted professional insurance advisers, insurance brokers play a vital role in ensuring that customers are not harmed by the lack of suitable due diligence in relation to insurer selection.

Much has been written on the subject of insurer selection. As recently as August 2018 the FCA provided new guidance on its website highlighting the need for insurance brokers to exercise due diligence when selecting insurers. The expectation is that insurance brokers can demonstrate that they have given careful consideration to where they place their customers' insurances.

The failures of Alpha, Enterprise and Gable highlighted the harm that can be caused to individuals, intermediaries and the wider insurance market when insurers fail to meet their commitments. These were unrated insurers operating in the UK under EEA freedom of services passporting arrangements. Over 1 million policyholders had to find alternative insurance cover and the insurance industry funded millions of pounds worth of compensation to policyholders paid by the UK Financial Services Compensation Scheme (FSCS).

More recently New Nordic Advisors put its wholly-owned Danish subsidiary Qudos Insurance into liquidation and CBL Insurance, the parent company of Ireland-based CBL Insurance Europe and CBL Insurance in New Zealand, was put into liquidation by the Auckland High Court.

This article looks at some of the steps brokers can take in response to the challenges of a diverse and competitive insurance market.

Due diligence factors

Firms can take into account a range of factors in deciding whether or not to use a particular insurer. Examples, including those put forward by the FCA, include:

- **Insurers' Solvency and Financial Condition Report:**
Solvency II (SII) is the solvency framework implemented in 2016 as the capital adequacy regime for the European insurance industry. SII requires insurers to publish an annual solvency and financial condition report (SFCR) which must cover the business of the undertaking, its system of governance, its risk exposure and information on valuation methods and capital management. A key figure and indicator is the solvency coverage percentage or solvency ratio. Generally speaking, a high solvency ratio indicates a healthy company, while a low one indicates a greater possibility of default. SFCRs are usually publicly available on insurers' websites.
- **Credit ratings:**
Whilst some data concerning a firm's financial strength can be obtained directly from the insurer and/or the SFCR, brokers may also refer to independent credit rating agencies such as Standard and Poor's, Fitch, AM Best or Moody's. An insurer's credit rating is based on the analysts' opinion of the company's financial strength. Each agency has its own rating scale. Standard and Poor's for example, uses a rating scale from AAA (the highest) to D (in default). Some agencies make headline financial strength ratings available online but detailed financial reports, which are more forward-looking and objective, tend to come at a cost.

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- **FCA and Financial Ombudsman Service (FOS) complaints data:**

Although published complaints data may be of limited use in relation to commercial customers, firm-specific complaints data available via the FCA website might provide an indicator of how the insurer treats customers.

- **Audited accounts of insurers:**

UK company accounts are filed at Companies House but there may not be an equivalent for overseas firms. Concerns should be raised if the insurer's accounts have not been filed as expected or if there are clear adverse features.

- **BIBA's Litmus Test:**

This is an online facility available to BIBA members. It provides some financial analysis of unrated insurers using several key indicators and a comparison of financial ratios against the wider insurance market.

- **FCA Register:**

Entry on the Financial Services Register is a pre-requisite for conducting insurance business in the UK. Many unrated insurers, often based elsewhere in the European Economic Area (EEA), are listed. Although regulators all over the world undertake some prudential checks on the firms they regulate they cannot ever guarantee a firm's ongoing financial security or its culture. Currently (pending Brexit) UK insurers and EEA insurers passporting in on a branch basis are automatically covered by Financial Ombudsman Service (FOS). Firms on a services passport may be FOS protected on a voluntary basis. The Financial Services Compensation Scheme (FSCS) covers eligible claims in respect of policies issued by insurers established in the UK or another EEA state. If the insurer under consideration is not covered by the FOS or FSCS, firms should check whether there is a dispute resolution and/or compensation scheme in the home state, and whether UK customers are eligible.

Brokers may have "difficult to place" risks and in the very competitive world of general insurance may need to consider using a foreign-based/unrated insurer that may operate outside the influence of UK insurance regulations. This can be a challenge for insurance brokers and great care needs to be taken to ensure that they are acting in the best interests of the customer in these situations.

Insurer identity

An important factor is for brokers to ensure they clearly detail the name and address of the insurer. It is quite common to see brokers' documentation which does not provide details of the actual insurer but only provides detail of the Managing General Agent (MGA) or wholesale broker in the distribution chain. If customers are not made aware of the identity and location of the insurer they are not in a position to make an informed decision as to where their insurance is being placed.

Alternative perspective

Interestingly, a recently reported case has highlighted litigation against a broker which resulted in an out of court settlement of nearly £100,000 to a commercial customer who had claimed an overpayment of premiums for three consecutive years for **not** using unrated insurers.

The circumstances of this case are somewhat unusual but they highlight a number of issues:

- The broker did not, as a matter of policy, place business with unrated insurers.
- The broker had not made clear to the customer that it would not therefore cover all of the market (Professional Indemnity) when seeking terms.
- The customer had made it known to the broker that price was the number one priority but no-one had considered the question of use of unrated insurers.
- It was shown to the satisfaction of the broker's PI insurers' lawyers that *"the broker knew or ought to have known that the customer specifically asked for the least expensive qualifying cover available in the market"*.

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- It was also shown that if the unrated insurer had failed the customer would have been eligible for protection by the policyholders' protection scheme and would suffer only a small net loss.

Summary

Brokers need to consider and measure both the benefits and risks when recommending any insurer, given the possibility of litigation against them if the cover fails. Enhanced due diligence would be particularly important where the insurer is not well-known in the market, is newly established, is offering unusual covers, is abnormally competitive or is based in a location not known for its developed insurance infrastructure.

Establishing the customer's specific demands and needs is essential and should include whether the customer requires, along with other factors, the most competitive premium and would have the risk appetite to consider being insured by an unrated insurer. If the firm is not prepared to use unrated insurers this should be made clear to the customer.

The FCA's expectation is that insurance brokers

- can demonstrate that they have given careful consideration to where they place their customers' insurances
- have provided customers with details of the identity of the actual insurer in their literature

The FCA is planning to do further work to verify that insurance brokers are conducting appropriate due diligence on the insurers they use.

What do we need to do now?

- Establish your business strategy for using unrated insurers or not, as the case may be. A good test may be to ask yourself whether you would be comfortable placing the customers' business with an insurer where you personally would be happy to be a policyholder.
- Where your strategy does not include such use make it clear to customers at the outset that your scope of service does not include using unrated insurers (which are insurers that do not carry an insurer financial strength rating given by international rating agencies, such as Standards and Poor's (S&P), Moody's, Fitch Ratings and A.M. Best) including, where appropriate, in your TOBA.
- Where your strategy does include using unrated insurers carry out and document appropriate due diligence including whether the jurisdiction of the FOS applies and whether the customer would be eligible for protection by a policyholders' protection scheme (such as the FSCS).
- Check that you meet all requirements for disclosure, ensuring the customer is given appropriate information about the insurance in good time and in a comprehensible form so they can make an informed decision and ensure the customer is made aware of the name and address of the actual insurer.
- When establishing customers' specific demands and needs take into consideration the risk appetite of the customer in relation to unrated insurers and, where appropriate, provide the customer with details of the benefits and risks of using such insurers.
- If the customer agrees to or requests the use of an unrated insurer, provide a written "health warning" and consider asking the customer to sign and return a copy in acknowledgment.
- Check the cover under your PI policy – policies may exclude cover in respect of insurer solvency and some may place restrictions on the use of certain types of insurer.

If you would like any help or information on any FCA regulation issues, ICS Services, e-learning or anything else we might be able to assist you with, please contact your usual ICS representative, Head Office on 01892 539600 or admin@insurancecompliance.co.uk

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The above information is a summary of certain matters which will affect the majority of firms conducting Insurance Mediation and reflects ICS's views at the date of publication. Each firms' requirements are individual and rules are regularly changing; it is therefore important that you always seek specific advice from ICS before acting on anything contained in this publication.

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