INSURANCE BROKERS

An Industry Accounting and Auditing Guide

Fourth Edition

Robin Oakes, Mark Grice and Sarah Ouarbya,
all of Mazars LLP

CCH
a Wolters Kluwer business

145 London Road
Kingston upon Thames
Surrey KT2 6SR
Tel: +44(0) 870 777 2906
Fax: +44(0) 208 247 1184
E-mail:info@cch.co.uk
Website: www.cch.co.uk

© 2006 Wolters Kluwer (UK) Ltd

ISBN 1-84140-795-X

All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means, or stored in any retrieval system of any nature without prior permission, except for permitted fair dealing under the Copyright, Designs and Patents Act 1988, or in accordance with the terms of a licence issued by the Copyright Licensing Agency in respect of photocopying and/or reprographic reproduction.

Application to reproduce extracts in other published works shall be made to the publishers. Full acknowledgement to author, publisher and source must be given. Material is contained in this publication for which copyright is acknowledged. Permission to reproduce such material cannot be granted by the publisher and application must be made to the copyright holder.

Crown copyright is reproduced with the permission of the Controller of Her Majesty's Stationery Office. Views expressed in this publication are the authors' and are not necessarily those of the Institute or the publisher. Whilst every effort has been made to ensure accuracy, the author and publisher can accept no responsibility for any errors contained in this publication. Nor can they accept any responsibility for any loss occasioned to any person acting or refraining from action as a result of any material in this publication.

Note: Use of FSA material does not indicate any endorsement by the FSA of this publication, or the material or views contained within it.

British Library Cataloguing-in-Publication Data.

A catalogue record for this book is available from the British Library.

Typeset by Columns Design Ltd, Reading
Printed by Krips bv

Contents

Foreword by Eric Galbraith, Chief Executive BIBA **xi**
Preface **xiii**

Part I Introduction **1**

Chapter 1—The insurance industry 3
1.1 Introduction 3
1.2 Insurance 3
1.3 Development of classes of insurance 4
1.4 Direct and reinsurance business 9
1.5 The insurance market 9
1.6 Sellers: the insurer 10
1.7 Intermediaries 13
1.8 Direct writers 16

Chapter 2—The broker's world 17
2.1 Introduction 17
2.2 Matching risks 18
2.3 Presenting the risk 19
2.4 Placing risks 21
2.5 Handling claims 22
2.6 Brokers and the law of agency 23
2.7 Errors and omissions 25
2.8 Corporate structure 26
2.9 Types of insurance broker 28
2.10 Trade associations 29
2.11 Other trade bodies 30

Part II Regulation **33**

Chapter 3—The FSA and the FSA Handbook 35
3.1 Introduction 35
3.2 Scope of the FSA's regulation 36
3.3 Obtaining FSA authorisation 40
3.4 Passporting to or from another EEA state 41
3.5 Approved persons regime 42
3.6 Controlled functions 42

3.7 The FSA Handbook 43
3.8 The FSA's high-level standards 44
3.9 Prudential standards 48
3.10 Business standards 54
3.11 Regulatory processes 56
3.12 Redress 57
3.13 Specialist sourcebooks 57
3.14 Tailored handbooks 57
3.15 Handbook guides 58

Chapter 4—The client money rules 59
4.1 Introduction 59
4.2 Scope of the client money rules 60
4.3 Agent of the insurer 60
4.4 Holding client money 61
4.5 Segregation and operation of client money accounts 63
4.6 The client money calculation 65
4.7 FSA review of the client money regime 69

Chapter 5—The insurance conduct of business rules 70
5.1 Introduction 70
5.2 ICOB 1 Application and purpose 71
5.3 ICOB 2 General rules (including unfair inducements) 73
5.4 ICOB 3 Financial promotions 74
5.5 ICOB 4 Advising and selling standards 75
5.6 ICOB 5 Product disclosure 78
5.7 ICOB 6 Cancellation 82
5.8 ICOB 7 Claims handling 83

Chapter 6—The retail mediation activities return 84
6.1 Introduction 84
6.2 Contents of the RMAR 84

Chapter 7—Accredited Lloyd's Brokers 88
7.1 Introduction 88
7.2 Accreditation requirements 88
7.3 Lloyd's coverholders 90

Chapter 8—Personal investment firms 91
8.1 Introduction 91
8.2 Category of authorisation 91
8.3 Financial resource requirements 93

Part III Management and Control 101

Chapter 9—Organisation and structure 103
9.1 Introduction 103
9.2 High street broker 103
9.3 International brokers 104

9.4 IT systems and data management 109

Chapter 10—Financial management 115
10.1 Introduction 115
10.2 The high street broker 115
10.3 International brokers 131

Chapter 11—Corporate governance, internal controls and risk management 143
11.1 Introduction 143
11.2 Corporate Governance 143
11.3 Systems and controls 144
11.4 Internal audit 146
11.5 Risk management 148
11.6 Conclusion 150

Part IV Accounting and Financial Reporting 151

Chapter 12—Basic accounting and document flow 153
12.1 Introduction 153
12.2 Central accounting bureaux 153
12.3 Premiums 154
12.4 Claims 156
12.5 Reinsurance 157
12.6 Facultative reinsurance 157
12.7 Treaty reinsurance 157
12.8 Basic accounting systems 158
12.9 Accounting for brokerage 159
12.10 Accounting for claims 164
12.11 Accounting for reinsurance 165
12.12 Balances with an insurer or an insured 166
12.13 Electronic trading systems 166

Chapter 13—Profit and loss account 168
13.1 Introduction 168
13.2 Profit and loss account formats 169
13.3 Accounting principles 170
13.4 Turnover 171
13.5 Segmental analysis 172
13.6 Continuing and discontinued operations 173
13.7 Accounting policies for brokerage 174
13.8 Fees and commissions 177
13.9 Claims handling fees 178
13.10 Expenses 178
13.11 Deferred brokerage 179
13.12 Foreign currency gains and losses 182
13.13 Foreign branches 183
13.14 Currency hedging 184

13.15	Credit writebacks	185
13.16	Exceptional items	186
Chapter 14—Balance sheet		187
14.1	Introduction	187
14.2	Goodwill	187
14.3	Investments	187
14.4	Insurance debtors and creditors	190
14.5	Funding and bad debts	196
14.6	Financial instruments	196
14.7	Share-based payment	197
14.8	Group accounts	198
Chapter 15—Other information in the financial statements		200
15.1	Introduction	200
15.2	Cash flow statement	200
15.3	Statement of total recognised gains and losses	202
15.4	Directors' report	203
15.5	Operating and financial review (OFR)	203
Chapter 16—International Financial Reporting Standards		206
16.1	Introduction	206
16.2	Voluntary adoption	206
16.3	IFRS and the Alternative Investment Market (AIM)	207
16.4	Potential advantages and disadvantages of IFRS conversion	207
16.5	First-time adoption	208
16.6	Format and content of financial statements	208
16.7	Revenue recognition	211
16.8	Goodwill	212
16.9	Insurance debtors and creditors	213
16.10	Financial instruments	214
16.11	Share-based payment	217
Part V External audit		**219**
Chapter 17—Statutory audit		221
17.1	Introduction	221
17.2	Appointment	221
17.3	Audit approach and planning	222
17.4	Risk assessment	223
17.5	Materiality	225
17.6	Audit procedures	225
17.7	Tests of controls	226
17.8	Substantive procedures	228
17.9	Computer-based audit techniques	229
17.10	Fraud	232
17.11	Reporting to regulators	232
17.12	Detailed audit areas	235

17.13 Brokerage and other income 235
17.14 Reinsurance brokerage income 239
17.15 Claims 240
17.16 Binding authorities 240
17.17 Pools 242
17.18 Insurance debtors and creditors 242
17.19 Client money balances and transactions 243
17.20 Bureau balances 245
17.21 Company balances 246
17.22 Binders and bordereaux 246
17.23 Directors' transactions 246
17.24 Consolidation issues 248
17.25 Goodwill 248
17.26 Going concern 249
17.27 Contingencies and commitments 250

Chapter 18—Auditors' reports to the FSA 252
18.1 Introduction 252
18.2 Engagement terms 252
18.3 Auditors' duty to report directly to the FSA 252
18.4 Client money audit for general insurance intermediaries 252
18.5 Personal investment (PI) firms 254

Part VI Taxation 257

Chapter 19 —Value added tax and insurance premium tax 259
19.1 Introduction 259
19.2 Basic principles of VAT 259
19.3 Place of supply and the concept of belonging 260
19.4 Terms of liability 260
19.5 The export of goods 261
19.6 Summary of liability to VAT for a UK broker 261
19.7 Partial exemption 262
19.8 Direct attribution 262
19.9 Calculation of recoverable residual input tax 262
19.10 Annual adjustment 263
19.11 De minimis 263
19.12 Accounting for output tax 263
19.13 Management service charges 264
19.14 Accounting for input tax 266
19.15 Group treatment for VAT 266
19.16 The meaning of a 'permitted' insurer 266
19.17 Reinsurance business 267
19.18 The value of a supply 267
19.19 Territorial limits of the European Union 267
19.20 Andersen and current developments 268
19.21 Insurance premium tax 269

Chapter 20—Direct taxation 270
20.1 Introduction 270
20.2 Accounting for income 270
20.3 Premiums temporarily invested 271
20.4 Anti-avoidance 272
20.5 Foreign currency 272
20.6 Old insurance balances 273

Part VII Appendices 275

Appendix 1—Statutory Accounts 277

Appendix 2—Glossary 324

Index 389

Foreword

Since the first edition of this guide was published, much has happened in the broking industry.

As I am sure most of you would concur, the most significant development has been the introduction of statutory regulation by the Financial Services Authority.

In this regulated environment all brokers must be aware of their accounting and auditing obligations, and this guide provides practical guidance and assistance for all those practising in our industry.

The broker community currently faces many challenges, but there are also many opportunities to strengthen our presence in the market and reinforce our position as the leading authority and consumer champion of the industry.

With support from all those stakeholders around the industry I am confident that brokers and intermediaries will embrace all challenges and continue to build on our success. I congratulate Mazars on once again producing a quality reference guide for the industry and hope you will find it useful.

Eric Galbraith
Chief Executive
BIBA

Preface to the fourth edition

This fourth edition has required an almost complete rewrite of the guide. In four years the insurance broker's world has gone through enormous change, both commercially and financially. In fact the interaction between accounting and regulation has probably been the most significant driver. Eliot Spitzer, the New York Attorney General, has played his part in reshaping the broker's ability to generate income and design innovative products and client charging policies. The setters of financial reporting standards have established new levels of disclosure and accountability. In the UK, the regulators in the form of the FSA have introduced teeth to the practice of controlling the industry for the policy-holder's benefit.

For this reason I want to acknowledge the considerable help from Sarah Ouarbya, one of our senior insurance technical managers at Mazars LLP, who has done most of the rewriting. She has been helped by Howard Jones of our tax team, Stephen Temple from our technology and systems assurance team, and Rebecca Scott, part of our governance, risk management and internal audit group. In addition, Paul Bennett, our insurance technical director, Sam Porritt, one of our insurance managers, and Mark Grice, my partner who heads up our insurance broker practice, have given their usual valuable input.

We are also grateful to Peter Staddon, the technical director at BIBA, who has 'enjoyed' reading the complete typescript and Eric Galbraith, BIBA chief executive, for his kind Foreword.

CCH continue to be the publishers and Nicole Johnson and Christopher Long have given us their usual high level of support and encouragement.

This edition covers the requirements of the FSA as they affect intermediaries, including client money rules and insurance conduct of business rules, and the process to become an accredited Lloyd's broker. It also addresses management and control, including risk management, direct and indirect taxation, international financial reporting standards and international standards of auditing (UK and Ireland). All these are areas of much higher profile than when we published our last edition.

This is also the last edition I shall edit before I retire from Mazars. During over 25 years in the London Market I have seen huge changes in many areas. In the past few years those changes have gathered pace at an alarming rate. However the market remains as vibrant and innovative as it always has. Some players aspire to be larger, some wish to retain their independence; some want to remain niche, some to

become more general; some embrace new technology willingly, others recognise they must not be left behind in a constantly changing and competitive environment. Wherever you fall in that scenario, you will find help in this book.

However, as always, neither Mazars LLP nor CCH can, of course, take responsibility for any loss resulting from the material in this publication.

Robin Oakes,
Sarah Ouarbya and Mark Grice
October 2006

Chapter 1 – The insurance industry

1.1 Introduction

To appreciate the role of the insurance broker in an insurance environment it is necessary to have a basic understanding of the operation of the insurance industry as a whole. It is a global industry and the basic principles by which it operates are universal.

The European Union (EU) has taken considerable interest in the insurance industry. Its vision a single insurance market, promoting economic efficiency and market integration, requires a common framework, to allow insurers to operate throughout the EU and to establish and provide services freely.

The legal framework must also protect customers, particularly individuals, where the safe delivery of promised benefits can be vital. This is achieved by a common prudential framework, founded on three generations of life and non-life Directives, harmonising essential rules. This framework needs to be updated, revised, completed and—where possible—simplified to respond to market developments and product sophistication. These Directives have been issued with a view to establishing a 'level playing field' across the Union. Consequently these have had a significant effect on the UK market and insurance intermediaries. Unfortunately not all EU members have implemented some of these directives, especially those relating to insurance brokers. As a result UK brokers may be at a disadvantage operating in some European countries.

The remainder of the book will discuss the evolution and operation of the insurance broker in the United Kingdom, the impact of regulation, management and control, the accounting and financial reporting requirements and external audit and taxation implications.

1.2 Insurance

In its simplest form, insurance involves one party (the insured) paying a sum of money (the premium) to another party (the insurer or underwriter). For this consideration, the insurer bears the risk—the possibility of loss or damage arising from a particular event happening. If the event covered by the insurance policy occurs, the insurer agrees to pay the claim arising up to the sum insured, which in some instances may be unlimited. The insurer keeps the premium whether or not a claim is paid. Generally, a number of risks are accepted and the premiums are

invested in a fund from which claims are met as they arise. Simplistically, the insurer expects that his total premiums, and an investment return on the cash representing those premiums, will exceed his total claims and expenses of administering the operation.

The primary function of insurance is to spread the financial losses of a few insureds over the many who have no losses. Contributions made to the fund from which these losses will be met are related to the probability and frequency of their occurrence and their expected cost.

Insurance also allows:

(a) the release of financial and management resources for the insured, which would otherwise be occupied with risk management;
(b) economies of scale for the insurer;
(c) benefits to all parties from specialisation;
(d) the opportunity to invest funds to provide added security to the insured;
(e) society as a whole to benefit by easing the burdens on social security schemes; and
(f) a business to continue trading after a potentially catastrophic event.

The main elements of insurance are:

(a) an insurance contract: a legally binding agreement between two or more parties setting out the terms of the insurance and the object or liability insured;
(b) an insurable interest: a financial involvement in the risk insured, which may be personal, in connection with assets owned directly, or by a third party, arising from some contingent liability or other event in which the insured has rights or an interest;
(c) *uberrima fides*: utmost good faith by both parties, which involves full disclosure of all material facts of which a prudent underwriter should be aware in assessing the risk;
(d) indemnity: the insured should be restored to the same financial position as existed before the loss occurred subject to the amount of the sum insured and other terms written into the contract; and
(e) subrogation: the insurer can assume another's rights against a third party, or has the right to make a claim in the name of another person. Thus the insurer provides an indemnity to the insured and recovers the loss from the third party.

1.3 Development of classes of insurance

Insurance in one form or another has been a feature of commercial life for at least 4,000 years. It developed initially where goods were transported by sea. One of the earliest recorded insurance arrangements was described by the Greek prosecutor, Demosthenes, over 2,000 years ago. He told the court in Athens that two men had

advanced 3,000 drachmas, which they would lose should a cargo of wine be lost or shipwrecked during its journey through the Bosphorus. The arrangement was that if the cargo were safely delivered the full sum assured would be repaid, together with a bonus, the amount of which depended on the time of year and thus the risk of shipwreck. Insurance has developed over the centuries in order to satisfy the changing needs of individuals and businesses seeking protection against financial loss. As a result, in the United Kingdom there are now a number of recognised classes of business, of which the most important are the general classes of marine, fire, accident and health, liability, other property and pecuniary losses, motor and aviation, and the special class of life assurance. Each of these types of business has its own particular features, which are introduced in the following paragraphs.

1.3.1 Marine

The Lombards, merchants from northern Italy, introduced marine insurance to Britain in the fourteenth and fifteenth centuries.

However, their domination of business caused considerable public resentment and led to the imposition of severe restrictions during the reign of Elizabeth I. The Lombards emigrated and British underwriters were able to capitalise on the marine insurance expertise they left behind. Marine business was therefore the first class of insurance to develop in Britain. The oldest surviving British insurance policy dates back to 1547 and relates to a voyage from Cadiz to London. The number of marine insurance transactions increased rapidly, and by 1575 a register of marine policies was introduced through the Chamber of Assurances. This in turn led to the standardisation of policy wordings. The Chamber of Assurances provided the venue for the Court of Arbitration, which was established in 1601 to settle disputes arising from the application of the terms of marine policies.

Marine insurance today is largely governed by the Marine Insurance Act 1906, which was a codification of previous case law. The Act is fundamental to an understanding of marine insurance.

The function of marine insurance is to cover the risk of damage, injury or other losses caused by collision, fire or similar ‘perils of the sea’. There are three elements of risk: hull (the vessel itself), cargo (the goods consigned to be carried by the vessel) and freight (the charges for transporting the goods). Policies may be written to cover a period of time, a particular voyage or a combination of the two.

Over the years cargo cover has been extended to include goods in transit and specie whether on land or sea. Initially it covered the transportation of goods from the docks to a warehouse but now delivery from the storage depot to its final destination can be insured by marine underwriters. Specie is the physical risk to the financial industry of the loss of, for example, cash, securities, credit cards, or travellers’ cheques.

1.3.2 Fire

Financial protection for property became particularly important with urban growth. Fire insurance developed towards the end of the seventeenth century after the

Great Fire of London in 1666. The first fire insurance company was established in 1680. The early fire insurance companies affixed metal fire marks to the outside wall of policyholders' premises so that the fire brigades, which were by and large controlled by the insurance companies, could identify with whom the property was insured. The Tooley Street fire of 1861 caused immense damage to the warehouses along the Thames in the middle of London, resulting in claims totalling £1,000,000, and led to a reappraisal of the basis for computing premiums. The reappraisal included a penalty for policyholders with poor fire precautions. Parliament also passed an Act establishing a fire service for London, run by the City.

Fire policies today are in standard form and cover damage to property caused by fire, lightning or explosion. They are also subject to a number of standard exclusions. It is possible to obtain cover for special perils, such as natural events, or to cover consequential loss.

1.3.3 Accident and health

The Industrial Revolution brought with it specific personal risks, which provided the opportunity for the emergence of accident and health insurance. This began in 1848 with insurance in respect of railway accidents and developed to provide compensation for all accidents and sickness. The main cover provided today is for personal accident, sickness and permanent health.

1.3.4 Liability

The growth of liability insurance was also precipitated by the Industrial Revolution. There are two main categories of liability insurance: employers' and public.

In the early days of industrialisation, employers did not accept much responsibility for sickness or injuries sustained by workers in the course of their employment, on the principle that the employee had agreed to accept the risk of being injured by accepting employment. There was also a legal defence known as 'common employment', which meant that the law protected employers from liability where one employee was injured as a result of another employee's actions. Liability could be avoided if an employee contributed, in even the smallest way, to his own injury. In 1880 the Employers' Liability Act gave some workers additional legal rights, but it was only in 1972 that employers were compelled to take out insurance to cover the cost of compensation where an employee is injured by the employer's fault.

Public liability insurance covers the insured where:

(a) others suffer loss to person or property through the insured's careless or negligent actions;
(b) the loss results from the insured's defective goods; or
(c) the liability is imposed by statute.

Variants on public liability include professional indemnity or errors and omissions cover which includes negligence by professional advisers, and product liability.

1.3.5 Other property and pecuniary losses

Theft cover was first provided in 1887 as an extension of a fire policy. In the following decade, theft insurance developed as a separate form of business and may now cover damage to buildings caused during a burglary, in addition to loss of goods by theft.

Fire and theft policies cover claims arising from specific perils but not from accidental damage or loss. A logical progression was the 'all risks' policy, which covers specified property against loss or damage from almost any cause. 'All risks' cover was first introduced at the end of the nineteenth century.

Property cover now includes traditional risks such as earthquake, flood and windstorm, and emerging risks including terrorism and damage caused by computer viruses.

1.3.6 Motor

The first motor vehicle appeared in Britain in 1894 and within a few years insurance cover became available to motor vehicle owners. The Road Traffic Act 1930 made it compulsory to have insurance against injury to third parties (except passengers). The Road Traffic Act 1960 extended that requirement to include passengers, and the Road Traffic Act 1988, implementing the EC Second Motor Directive, requires insurance against third party property damage. The normal minimum motor insurance is 'third party only', which provides cover against damage to the property of others in addition to personal injury as required by statute. However, fully comprehensive cover is available to cover damage to the insured's vehicle caused by fire, theft, accidental collision or malicious damage.

1.3.7 Aviation

Aviation insurance is the most recent major class of business. It has developed since the First World War. It is complex and highly specialised and covers damage to aircraft, cargo and air travellers' baggage, and personal accident, public liability and product liability. Parliament has imposed strict controls over this class of business.

A natural extension of the aviation market is that of satellite and space coverage for the increasing number of commercial extra-terrestrial activities that now take place.

1.3.8 Life

The EU directives distinguish between general insurance and life assurance and the insurance industry has also applied these distinctions in its organisation. Life assurance, like marine insurance, has ancient historical roots. For example, Romans and Greeks formed associations known as funeral clubs, to which they paid contributions and out of which burial costs were met.

The first recorded instance of life assurance in Britain relates to a policy written in 1583 in respect of a William Gibbons. A group of individuals agreed to provide cover for him for a period of 12 months. At the bottom of the policy they added the words: 'God send the said William Gibbons health and a long life'. Unfortunately, Mr Gibbons died after 11 months.

For the next century there was little change in the type of life assurance provided, with most policies being for the short term. In the mid-eighteenth century policies were introduced which guaranteed that a minimum sum would be paid in the event of death. At about the same time, actuarial principles evolved, based on the work of mathematicians who produced what became known as mortality tables. These tables compute in mathematical terms the likelihood of the death of a person of a given age. Actuarial principles gave insurers a scientific basis for calculating premiums, depending on the age of the individual when the policy was taken out. The Life Assurance Act 1774 introduced a degree of regulation to the life assurance market, in particular prohibiting insurances upon lives,

> 'except in cases where the persons insuring shall have an interest in the life or death of the person insured'.

Life assurance provides financial security and protection for dependants by the payment of a lump sum or other benefits on the death of the insured. This is known as 'term' business. Life assurance is, however, a unique class of insurance business because it may also be used for long-term investment purposes. Such policies may be described as endowment, and are linked to particular forms of investments such as unit trusts. Variants of such policies provide annuities and pensions.

The principal differences between life assurance and general insurance business may be summarised as shown in the table below.

Life assurance	***General insurance business***
Contracts cover a long period	Contracts are usually made for a short period of one year or less
The premium is usually set at the beginning of the contract	The premium varies on renewal
The size of the claim is determined at the beginning	The size of the claim varies dependent on the loss arising
The risk of a claim being made increases during the period of the contract	The risk exists at the same level throughout the contract
A policy may acquire a surrender value, in return for the policyholder surrendering his rights	Payment arises only in the event of the insured risk occurring
Payment of a claim completes the contract	More than one claim can arise

1.4 Direct and reinsurance business

The classification of insurance business into direct and reinsurance is quite separate from, and is superimposed upon, any analysis by class of business. The EU has also followed this distinction in its directives. Direct insurance involves acceptance by an insurer of up to 100% of the risk placed from the general public. A variation is co-insurance, where a number of insurers each bear a proportion of the risk under separate contracts. Reinsurance literally means 'insuring again' and is the practice by which the direct insurer 'lays off' to another insurer a proportion of the risk he has accepted from the initial insured. It is a contract between insurers and does not involve the general public who first placed the insurance.

Reinsurance thus serves to spread the impact of financial loss between insurers in the event of a claim. Consequently, it reduces the financial effect of uncertainty of future events for the direct insurer and may, depending on the terms of the contract, replace a variable, unpredictable cost with a fixed maximum cost. It cannot, however, prevent a claim arising from an initial insured. Since the direct insurers can reinsure part of their risks, they are able to accept more of the original risk or to accept more risks and thereby spread their loss exposure over a wider range of business.

Insurers can accept reinsurance and direct business or they may specialise and write reinsurance only. A reinsurer may also reinsure part of the reinsurance risks written. The different types of reinsurance contract are described in detail in Chapter 12.

1.5 The insurance market

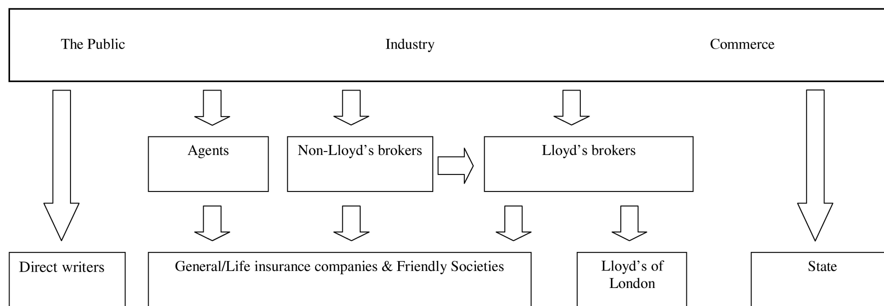
The United Kingdom insurance market is made up of three basic elements:

(a) the buyer or insured;
(b) the intermediary and the seller;
(c) the insurer or underwriter.

The latter category may be subdivided into direct sellers and reinsurers. Figure 1.1 illustrates the relationships between these three elements.

Direct sellers should not be confused with 'direct writers' which are insurance companies that sell direct to the insured without the involvement of an intermediary.

Figure 1.1 The insurance market



1.6 Sellers: the insurer

Insurers or underwriters have formed themselves into several different types of organisation, some of which are only found in the insurance industry. In the United Kingdom, there are insurance companies with various types of constitution, involved either in general or in life business, or in both (a 'composite' insurer) or specialising in a particular type of risk. The Society of Lloyd's ('Lloyd's') is a unique feature of the United Kingdom market. Members of the society, either individuals or corporate bodies, are known as 'Names' and are grouped in underwriting syndicates.

In essence the insurers bear or underwrite the risk under an insurance policy, whatever the nature of their organisation. In this book, the generic terms 'insurer' and 'underwriter' are used to refer to both insurance companies and Lloyd's syndicates.

The quality of the security behind an insurer is important to the insured. If the insurer's underwriting and investment are unsuccessful and other assets become eroded, settlement of claims will depend on the nature of the investment backing the insurer. Corporate insurers may be proprietary or mutual companies, or various forms of associations.

1.6.1 Insurance companies

The majority of insurance companies are proprietary companies which have limited liability and are owned by shareholders. These companies are now incorporated under the Companies Acts, although in the past they have been created by Act of Parliament, Royal Charter or Deed of Settlement. The profits of these companies, being essentially the excess of premiums plus investment income over claims, expenses and claims reserves movements, belong to the shareholders. Profits may be distributed by way of dividend or retained within the company to finance future expansion or to provide a further general reserve to improve the security of policyholders.

1.6.2 Mutual insurance companies and societies

Mutual insurance companies are owned by the policyholders, who share in any profits made by way of lower premiums or higher life assurance bonuses. Mutual companies have been formed by Deed of Settlement or Registration under the Companies Acts and are limited by guarantee, with the policyholders' maximum liability being restricted to their premiums or, at most, an additional £1. Many of the mutual insurers are specialist life assurance companies.

There are other mutual societies such as mutual indemnity associations, friendly societies and industrial life assurance offices. Mutual indemnity associations were established by trade associations, originally only accepting business from members of a particular trade. They were formed because the tradesmen felt that the premiums charged by their existing insurers were too high compared with their claims history, or because their insurance needs were not being met. In order to improve their financial base, many of these associations now accept business from the public and have become mutual or proprietary companies. Friendly societies usually transact industrial life assurance. They are registered under the Friendly Societies Acts and are run on a mutual basis, usually operating in the geographical areas around their registered office. Industrial life assurance offices are governed by the Industrial Assurance and Friendly Societies Acts. Both the offices and the societies issue life policies, generally for modest sums and to lower income groups.

1.6.3 Captive insurance companies

With the increasing costs of insuring risks, large national and multinational companies have formed captive insurance subsidiary companies to underwrite some or all of the group's insurable risks. This saves contributing towards direct insurers' overheads and allows a company to make full use of its risk evaluation and control techniques by paying premiums based on its own experience. The captive insurance company will retain some part of the risks written and reinsure the balance.

1.6.4 The Society of Lloyd's

The Society of Lloyd's is neither a company nor an insurer. It is a corporation which provides facilities for its underwriting members. It is these members or 'Names' who bear insurance risks.

The historical roots of Lloyd's lie in the seventeenth century, when merchants used to meet and transact business in coffee-houses around the City of London. One such coffee-house, owned by Edward Lloyd, became popular with businessmen having an interest in maritime undertakings, including insurance. The date on which this coffee-house was opened is unknown, although it was certainly in existence in the 1680s. Edward Lloyd became a source of information on maritime intelligence and in 1696 started publishing *Lloyd's News*. This publication was the forerunner of *Lloyd's List*, which is London's oldest newspaper.

Even after the death of Edward Lloyd, his name continued to be associated with insurance, despite the fact that the insurance market had moved to a new coffee-house. In 1771 a committee was formed to look for larger premises, with the result that the running of Lloyd's was transferred from the coffee-house owner to the insurers themselves. The Society of Lloyd's was incorporated in 1871 by Act of Parliament. The provisions of the Act included the objects of the Society, the right to make byelaws for its control, and the formation of a committee to administer it. As Lloyd's developed within a changing insurance market, further Acts were passed in 1911, 1925, 1951 and 1982. The most recent statute, the Lloyd's Act 1982, followed an enquiry under Sir Henry Fisher into the constitution and self-regulation of Lloyd's. The Act established a new Council, which has overall responsibility for and control of affairs at Lloyd's, including all rule-making and disciplinary powers.

London is still the centre for the world's marine insurance and shipping intelligence. Lloyd's continues to play a significant part in marine insurance but it now transacts all types of insurance except long-term life business.

Lloyd's insurances (with the exception of motor business) are generally transacted in the 'Room' in the Lloyd's building where each syndicate is represented by an underwriter. Advancements in technology mean however that the underwriter does not have to be physically present in the 'Room' to conduct business.

The underwriter assesses the various risks presented to the syndicate from the risk details set out on a document called a 'slip' and supporting documentation provided by the broker. The underwriter enters on the slip the proportion of the risk the syndicate is willing to carry. The underwriter then signs the slip underneath his 'line'—hence the term 'underwriter'. The introduction of computer systems has had a significant impact on Lloyd's and the handwritten slip is often replaced by electronic placing. There is a gathering momentum across the London insurance market to make more use of electronic processing to speed up business handling and for handwritten slips to become a thing of the past.

Every underwriting member, or Name, is committed by the underwriter for the proportion of the risk accepted on his behalf. The Name has to demonstrate adequate assets and make a deposit (Funds at Lloyd's) to support the volume of business transacted. This provides policyholder protection.

In the mid-1990s Lloyd's went through a major crisis following unprecedented levels of unforeseen claims and was 'rescued' through a programme of 'Reconstruction and renewal' and the formation of Equitas, a company that took on the Lloyd's market's insurance liabilities relating to 1992 and prior years of underwriting.

Names, who had formerly had unlimited liability, were allowed to limit their liability. As a result many continuing names incorporated themselves and continued underwriting. New investors also appeared in the market through a variety of corporate vehicles, some capitalised through the Stock Exchange. Others were backed by companies who wished to invest in the London insurance market. Many

of the latter are insurance or investment companies. Insurance companies investing in Lloyd's corporate vehicles may be able to make use of Lloyd's licences to operate throughout the world.

The price paid by Names to be released by Equitas from their old year liabilities was often high and many chose to leave the Lloyd's market. However, after a short period of decline, Lloyd's came back into favour once more as one of the world's leading carriers of risk, a position it continues to hold today.

On 1 January 2006 Lloyd's capacity (the level of insurance premium that could be earned by syndicates) was £14.8 billion. This capacity was provided by Names as follows:

- 13% by the worldwide insurance industry,
- 16% by the US insurance industry,
- 7% by Bermudan insurers,
- 47% by UK listed and other corporate entities,
- 7% by private individuals with limited liability, and
- 10% by private individuals with unlimited liability.

1.6.5 The State

The State acts as an insurer under the National Insurance Acts, which require all employees to contribute to the national insurance scheme. This scheme was introduced with the Beveridge Report in 1948 and was an extension of the Poor Laws, which began with the Elizabethan Poor Law Act 1601. National insurance has only been mentioned here for completeness; it is not within the scope of commercial insurance.

More relevant to the UK insurance market is Pool Re which was established jointly by the Government and the industry, under the Reinsurance (Acts of Terrorism) Act 1993, following a number of terrorist attacks, particularly in London. Pool Re is a mutual reinsurance company set up by the insurance industry through which insurers of commercial property and buildings in the UK can reinsure their terrorist liabilities. It has substantial reserves, and in addition HM Treasury acts as reinsurer of last resort.

1.7 Intermediaries

Although insurable risks can be placed direct by the insured with insurers, many risks are placed by intermediaries who act as an interface between the two parties. These are 'brokers' or 'agents'.

One of the earliest historical references to insurance intermediaries was in 1575, when mention was made of 'those' who assisted the merchants in buying and selling, and in their contracts, and who were concerned also in the writing of

insurances and policies. At first, when there were few people requiring insurance and relatively few underwriters, it was simple for the prospective insured to go direct to the underwriter. However, as ventures became more numerous, hazardous and complex, the services of a trusted and experienced intermediary became necessary. Similarly, because the potential losses being insured became so large that they exceeded the capacity of a single insurer, a skilled intermediary was employed, who would know how and where the risk could best be shared.

The early intermediaries differed from the brokers of today in that they were often engaged concurrently in other business activities. They charged fees to the insured according to the work involved, whereas today the broker is often remunerated by a commission (brokerage) received from the underwriter. Many intermediaries who work in the life and pensions class of business are paid by way of a fee charged to the insured. In general insurance many more complex risks are placed by brokers who similarly charge fees to the insured which relate to the amount of work necessary to place the business and subsequently service it. This practice may become more widespread as intermediaries address perceived conflicts of interest arising from the payment of brokerage by the insurer. Regulators around the world are focussing on these conflicts and also on disclosure to the insured where commission is still received by the broker.

Intermediaries include individuals, partnerships or companies who trade as insurance brokers, and building societies, banks, estate agents, solicitors, accountants and even travel agents. The Insurance Brokers (Registration) Act 1977 (IBRA) was the first attempt to regulate brokers and placed statutory limitations on the expressions 'insurance broker', 'assurance broker', 'reinsurance broker' and 'reassurance broker'. Many intermediaries referred to themselves as insurance consultants or agents, or used other terms which enabled them to avoid registration under the IBRA. The IBRA was repealed under the Financial Services and Markets Act 2000 (FSMA) and the industry set up the General Insurance Standards Council (GISC).

In January 2005, as a result of the EU's Insurance Mediation Directive 2002 (IMD), the Government re-imposed statutory regulation on general insurance and reinsurance intermediaries under the FSMA, having already brought those intermediaries which handle life and pensions business within its ambit. The regulation is now provided by the Financial Services Authority (the FSA). Its requirements in relation to intermediaries are discussed in detail in Part II of this book.

The text of Article 2.3 of the IMD defines 'insurance mediation' as:

> 'the activities of introducing, proposing or carrying out other work preparatory to the conclusion of contracts of insurance, or of concluding such contracts, or of assisting in the administration and performance of such contracts, in particular in the event of a claim.
> These activities when undertaken by an insurance undertaking or an employee of an insurance undertaking who is acting under the responsibility of the insurance undertaking shall not be considered as insurance mediation.
> The provision of information on an incidental basis in the context of another professional activity provided that the purpose of that activity is not to assist the

customer in concluding or performing an insurance contract, the management of claims of an insurance undertaking on a professional basis, and loss adjusting and expert appraisal of claims shall also not be considered as insurance mediation'.

In the same way as insurers may either specialise or deal in a variety of risks, so intermediaries may act for only one class of business, such as life assurance or marine, or for many. There are also intermediaries who specialise in direct or reinsurance business, and who operate internationally or nationally from single offices, in London or other towns and cities, or from a network of offices abroad or in the United Kingdom.

The main types of intermediary currently operating in the United Kingdom are insurance brokers, Lloyd's brokers who are accredited at Lloyd's, and insurance agents. These are discussed briefly in the following paragraphs, but a detailed treatment of the types and role of insurance brokers is given in Chapter 2.

1.7.1 Insurance brokers

An insurance broker is a person or firm who brings buyers and sellers of insurance or reinsurance together with a view to their entering an insurance or reinsurance contract. Insurance brokers act independently of insurers and have freedom of choice within the market on where to place business, subject to limitations set by the insured. They act as agents for the insured.

Lloyd's broking companies are a particular type of insurance broker who, in addition to placing business in the company market, can place business at Lloyd's. Indeed, staff from a Lloyd's broker are the only people who can enter the Room to place business. In order to act as a Lloyd's broker, the company must satisfy various criteria established by the Council of Lloyd's, although, as is discussed in Chapter 3, Lloyd's no longer has an ongoing regulatory function; this has now been taken over by the FSA.

There is also a significant class of independent non-broker intermediary who acts between the various other bodies in the market. Many of these are also regulated by the FSA.

1.7.2 Insurance agents

Insurance agents are appointed by the insurer and act only for those organisations which have appointed them. They are appointed representatives of an FSA authorised insurer, in other words basically insurance sales representatives operating primarily in those sections of the non-marine markets where the sums insured and the premiums are smaller and therefore of less interest to brokers. Since there is less need to spread risks between insurers, the broker's role is less important.

Agents are regulated by the FSA, do not give impartial advice and therefore must tell prospective clients they are tied agents. They are remunerated by means of a

commission which is paid every time a policy is placed or renewed, and which therefore acts as an incentive to ensure renewal.

People such as solicitors, estate agents, garage proprietors and accountants, although not directly connected with insurance, are well placed to identify clients who might require insurance cover and introduce them to the insurance company for which they act as agents.

1.8 Direct writers

A growing phenomenon in the UK insurance market and perhaps a modern development of the tied agent who collected premiums by calling 'door to door', is the direct writer. This term simply describes a situation where a person seeking insurance contacts an insurance company directly and takes out a contract of insurance without the involvement of an intermediary. Most household name insurance companies now have their own direct writing department or division.

The type of insurance contract that is placed this way is typically personal lines business, eg, home or motor insurance. Direct writers will not usually deal with any form of unusual or complex insurance needs but are moving into commercial cover particularly for small and medium sized businesses.

Contracts with a direct writer are arranged by telephone or on the internet. However, internet sales of insurance tend to work only for very standard policies and 'standard' insureds. A person seeking, for example, motor insurance who has a history of motoring offences will quickly find that the application cannot be processed over the internet and will be referred to a telephone service—or even be advised to consult a broker.