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LM1

London Market insurance essentials

2018 Study text

IUA of London International Underwriting Association

LIIBA London & International Insurance Brokers' Association

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London Market insurance essentials

LM1 study text: 2018

This edition is based on the 2018 examination syllabus to be examined from 1 January 2018 until 31 December 2018.

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Using this study text

Welcome to the **LM1: London Market insurance essentials** study text which is designed to cover the LM1 syllabus, a copy of which is included in the next section.

Please note that in order to create a logical and effective study path, the contents of this study text do not necessarily mirror the order of the syllabus, which forms the basis of the assessment. To assist you in your learning we have followed the syllabus with a table that indicates where each syllabus learning outcome is covered in the study text. These are also listed on the first page of each chapter.

Each chapter also has stated learning objectives to help you further assess your progress in understanding the topics covered.

Contained within the study text are a number of features which we hope will enhance your study:

Activities: reinforces learning through practical exercises.

Be aware: draws attention to important points or areas that may need further clarification or consideration.

Case studies: short scenarios that will test your understanding of what you have read in a real life context.

Consider this: stimulating thought around points made in the text for which there is no absolute right or wrong answer.

Examples: provide practical illustrations of points made in the text.

Key points: act as a memory jogger at the end of each chapter.

Key terms: introduce the key concepts and specialist terms covered in each chapter.

Learning points: provide clear direction to assist with understanding of a key topic.

Refer to: located in the margin, extracts from other CII study texts, which provide valuable information on or background to the topic. The sections referred to are available for you to view and download on RevisionMate.

Reinforce: encourages you to revisit a point **previously** learned in the course to embed understanding.

Revision questions: to test your recall of topics.

Sources/quotations: cast further light on the subject from industry sources.

Think back to: located in the margin, highlights areas of assumed knowledge that you might find helpful to revisit. The sections referred to are available for you to view and download on RevisionMate.

Useful websites: introduce you to other information sources that help to supplement the text.

At the end of every chapter there is also a set of self-test questions that you should use to check your knowledge and understanding of what you have just studied. Compare your answers with those given at the back of the book.

By referring back to the learning outcomes after you have completed your study of each chapter and attempting the end of chapter self-test questions, you will be able to assess your progress and identify any areas that you may need to revisit.

Not all features appear in every study text.

Note

Website references correct at the time of publication.

Examination syllabus

Chartered Insurance Institute

London Market insurance essentials

Objective

To provide an essential grounding in the operation of the London insurance market.

Summary of learning outcomes	Number of questions in the examination*
1. Understand basic terminology used within the general insurance market	6
2. Understand the fundamental principles of insurance	10
3. Understand the main classes of insurance written in the London Market	4
4. Understand the insurance cycle	1
5. Understand reinsurance within the insurance market	3
6. Understand the structure of the London Market	5
7. Understand the London Market regulatory and legal environment	10
8. Understand the importance of appropriate systems and controls	2
9. Understand data protection and money laundering legislation and requirements	2
10. Understand the broker's role in the way that business is conducted in the London Market	4
11. Understand the underwriter's role in the way that business is conducted in the London Market	3

*The test specification has an in-built element of flexibility. It is designed to be used as a guide for study and is not a statement of actual number of questions that will appear in every exam. However, the number of questions testing each learning outcome will generally be within the range plus or minus 2 of the number indicated.

Important notes

- Method of assessment: 50 multiple choice questions (MCQs). 1 hour is allowed for this examination.
- This syllabus will be examined from 1 January 2018 until 31 December 2018.
- Candidates will be examined on the basis of English law and practice unless otherwise stated.
- Candidates should refer to the CII website for the latest information on changes to law and practice and when they will be examined:
  1. Visit www.cii.co.uk/updates
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  3. Select your unit on the right hand side of the page

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LM1

Examination syllabus

1. Understand basic terminology used within the general insurance market

1.1 Explain the principle of good faith
1.2 Define the meaning of proximate cause
1.3 Define indemnity
1.4 Explain the concept of contribution
1.5 Explain what is meant by subrogation

2. Understand the fundamental principles of insurance

2.1 Describe the concept of risk
2.2 Explain the categories of risk
2.3 Explain the principle of the pooling of risks
2.4 Explain the difference between a peril and a hazard as this relates to insurance
2.5 Give examples of physical and moral hazards
2.6 List the types of insurable and uninsurable risks
2.7 Explain the basic purpose of insurance
2.8 Explain the primary and secondary functions of insurance
2.9 Explain the importance of the claims handling process

3. Understand the main classes of insurance written in the London Market

3.1 Describe the main classes of insurance written in the London Market
3.2 Describe the main features of the different classes of insurance

4. Understand the insurance cycle

4.1 Outline and explain the insurance cycle

5. Understand reinsurance within the insurance market

5.1 Explain the purpose of reinsurance
5.2 Describe the main terminology used in connection with reinsurance transactions

6. Understand the structure of the London Market

6.1 Describe the main providers in the London Market including Lloyd's, Company market and P&I Clubs
6.2 Explain the importance of the London Market and why clients may decide to place their business within this market
6.3 Explain the role of the London Market associations
6.4 Explain the way that business is transacted in the London Market

7. Understand the London Market regulatory and legal environment

7.1 Describe the role, aims, approach to regulation; and principles for business of the industry regulator
7.2 Describe the role of major international regulators, including licensing
7.3 Explain the governance of the Lloyd's Market
7.4 Examine and explain the role of the Financial Ombudsman Service and the Financial Services Compensation Scheme
7.5 Explain the basic powers of the industry regulator for the authorisation, supervision and regulation of insurers
7.6 Explain the basic powers of the industry regulator for the authorisation, supervision and regulation of insurance intermediaries
7.7 Define what is meant by a contract of insurance
7.8 Describe the essentials of a valid contract of insurance

8. Understand the importance of appropriate systems and controls

8.1 Explain the purpose of sanctions
8.2 Examine and describe the basic systems and controls to ensure adherence to EU, US and UK legislation

9. Understand data protection and money laundering legislation and requirements

9.1 Explain the principles, rights and restrictions of the data protection legislation
9.2 Explain the various requirements to ensure money laundering compliance when dealing with clients

10. Understand the broker's role in the way that business is conducted in the London Market

10.1 Explain the role and responsibilities of brokers
10.2 Explain the business process of broking and the parties involved
10.3 Explain the broker's role in the handling of premiums
10.4 Explain the broker's role in claims notification, investigation and settlement

11. Understand the underwriter's role in the way that business is conducted in the London Market

11.1 Explain the role and responsibilities of underwriters
11.2 Explain the role and responsibilities of the lead and following underwriters within the London Market

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Examination syllabus

Reading list

The following list provides details of various publications which may assist you with your studies.

Note: The examination will test the syllabus alone.

The reading list is provided for guidance only and is not in itself the subject of the examination.

The publications will help you keep up-to-date with developments and will provide a wider coverage of syllabus topics.

CII/PFS members can borrow most of the additional study materials below from Knowledge Services. CII study texts can be consulted from within the library.

New materials are added frequently - for information about new releases and lending service, please go to www.cii.co.uk/knowledge or email knowledge@cii.co.uk.

CII study texts

London Market Insurance Essentials. London: CII. Study text LM1.

Books (and ebooks)

Bird's modern insurance law. 10th ed. John Birds. Sweet and Maxwell, 2016.

Insurance theory and practice. Rob Thoyts. Routledge, 2010.*

Lloyd's: law and practice. 2nd ed. Julian Burling. Oxon: Informa Law, 2017.*

Periodicals

The Journal. London: CII. Six issues a year. Also available online via www.cii.co.uk/knowledge (CII/PFS members only).

Market magazine. Lloyd's of London. Quarterly.

Post magazine. London: Incisive Financial Publishing. Monthly. Also available online at www.postonline.co.uk.

Reference materials

Concise encyclopedia of insurance terms. Laurence S. Silver, et al. New York: Routledge, 2010.*

Dictionary of insurance. C Bennett. 2nd ed. London: Pearson Education, 2004.

The insurance manual. Stourbridge, West Midlands: Insurance Publishing & Printing Co. Looseleaf, updated.

*Also available as an ebook through Discovery via www.cii.co.uk/discovery (CII/PFS members only).

Examination guide

An examination guide, which includes a specimen paper, is available to purchase via www.cii.co.uk.

If you have a current study text enrolment, the current examination guide is included and is accessible via Revisionmate (www.revisionmate.com). Details of how to access Revisionmate are on the first page of your study text.

It is recommended that you only study from the most recent version of the examination guide.

Exam technique/study skills

There are many modestly priced guides available in bookshops. You should choose one which suits your requirements.

The Insurance Institute of London holds a lecture on revision techniques for CII exams approximately three times a year. The slides from their most recent lectures can be found at www.cii.co.uk/iilrevision (CII/PFS members only).

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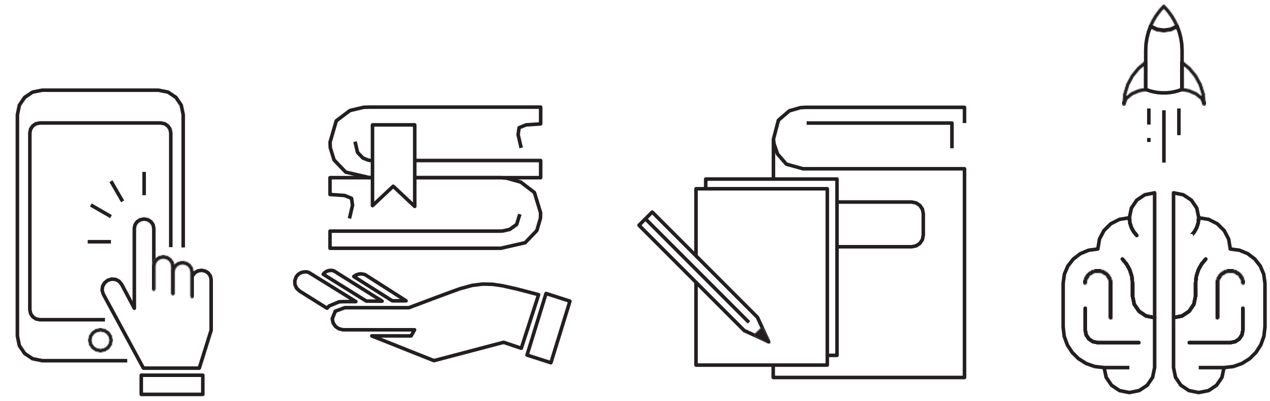

LM1 syllabus quick-reference guide

Syllabus learning outcome		Study text chapter and section
1.	**Understand basic terminology used within the general insurance market**	
1.1	Explain the principle of good faith	2D
1.2	Define the meaning of proximate cause	2F
1.3	Define indemnity	2G
1.4	Explain the concept of contribution	2H
1.5	Explain what is meant by subrogation	2I
2.	**Understand the fundamental principles of insurance**	
2.1	Describe the concept of risk	1A, 1B, 1C
2.2	Explain the categories of risk	1D
2.3	Explain the principle of the pooling of risks	1F
2.4	Explain the difference between a peril and a hazard as this relates to insurance	1G
2.5	Give examples of physical and moral hazards	1G
2.6	List the types of insurable and uninsurable risks	1E
2.7	Explain the basic purpose of insurance	1H
2.8	Explain the primary and secondary functions of insurance	1I, 1J
2.9	Explain the importance of the claims handling process	1K
3.	**Understand the main classes of insurance written in the London Market**	
3.1	Describe the main classes of insurance written in the London Market	3A, 3B, 3C
3.2	Describe the main features of the different classes of insurance	3A, 3B, 3C
4.	**Understand the insurance cycle**	
4.1	Outline and explain the insurance cycle	4A, 4B, 4C
5.	**Understand reinsurance within the insurance market**	
5.1	Explain the purpose of reinsurance	3D
5.2	Describe the main terminology used in connection with reinsurance transactions	3D
6.	**Understand the structure of the London Market**	
6.1	Describe the main providers in the London Market including Lloyd's, Company market and P&I Clubs	5A, 5B, 5C, 5D
6.2	Explain the importance of the London Market and why clients may decide to place their business within this market	5F
6.3	Explain the role of the London Market associations	5E
6.4	Explain the way that business is transacted in the London Market	5F, 8D, 8E, 9C

Syllabus learning outcome		Study text chapter and section
7.	**Understand the London Market regulatory and legal environment**	
7.1	Describe the role, aims, approach to regulation; and principles for business of the industry regulator	6A, 6B
7.2	Describe the role of major international regulators, including licensing	6C
7.3	Explain the governance of the Lloyd's Market	6D
7.4	Examine and explain the role of the Financial Ombudsman Service and the Financial Services Compensation Scheme	6F
7.5	Explain the basic powers of the industry regulator for the authorisation, supervision and regulation of insurers	6E
7.6	Explain the basic powers of the industry regulator for the authorisation, supervision and regulation of insurance intermediaries	8B
7.7	Define what is meant by a contract of insurance	2A, 2E
7.8	Describe the essentials of a valid contract of insurance	2B, 2C
8.	**Understand the importance of appropriate systems and controls**	
8.1	Explain the purpose of sanctions	7B
8.2	Examine and describe the basic systems and controls to ensure adherence to EU, US and UK legislation	7A, 7E
9.	**Understand data protection and money laundering legislation and requirements**	
9.1	Explain the principles, rights and restrictions of the data protection legislation	7C
9.2	Explain the various requirements to ensure money laundering compliance when dealing with clients	7D
10.	**Understand the broker's role in the way that business is conducted in the London Market**	
10.1	Explain the role and responsibilities of brokers	8A
10.2	Explain the business process of broking and the parties involved	8C, 8D
10.3	Explain the broker's role in the handling of premiums	8D
10.4	Explain the broker's role in claims notification, investigation and settlement	8E
11.	**Understand the underwriter's role in the way that business is conducted in the London Market**	
11.1	Explain the role and responsibilities of underwriters	9A, 9B
11.2	Explain the role and responsibilities of the lead and following underwriters within the London Market	9C

Introduction

LM1 – London Market insurance essentials starts the student on their learning journey within the London Market and is the first unit in both the Award in London Market Insurance and Certificate in Insurance (London Market).

It begins by introducing fundamental principles of insurance and risk as well as the reasons for buying and selling insurance. Your study text will also discuss the function of insurance within the wider economy and its further role to protect citizens.

Legal principles and terminology are also introduced as well as the main classes of business written in the London Market and the theory of the insurance business cycle.

The structure of the London Market is looked at in some detail to identify the various players and the flow of business around the market. The regulatory framework is also introduced and an overview is given of both national and international regulation as it might apply to both brokers and insurers operating in the London Market.

Finally, the unit will give the student a firm understanding of the role of the broker and underwriter within the wider context of the market. Some of the concepts outlined within this unit will be built on in more detail within unit LM2: London Market Insurance principles and practices, and encourage all students to better understand their role within the marketplace and how it operates around them.

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1

Fundamental principles of insurance

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Learning objectives

After studying this chapter, you should be able to:

- describe the concept of risk and risk transfer;
- explain the components of risk and the concept of risk management;
- explain the categories of risk and those that can be insured;
- explain the pooling of risk;
- explain the difference between peril and hazard and give examples;
- explain the basic purpose of insurance and the reasons for its purchase;
- list the various types of compulsory insurance; and
- explain the concept of insurance as a service industry.

Introduction

We start our studies by exploring the concept of risk and the various ways in which this word is used within the insurance business. We will look at the different types of risk and which are insurable, together with the things that enhance the risk itself.

In this first chapter, we will also look at the types of insurance that are compulsory, and the purposes and functions of insurance.

Key terms

This chapter features explanations of the following terms:

Compulsory insurance	Equitable premiums	Financial risks	Fortuitous event
Frequency	Fundamental risks	Hazard	Homogeneous exposures
Insurable interest	Law of large numbers	Moral hazard	Non-financial risks
Particular risks	Peril	Physical hazard	Pooling of risk
Pure risks	Risk	Risk management	Risk transfer
Service industry	Severity	Speculative risks	Uncertainty

A Concept of risk and risk transfer

No universally recognised definition for the term 'risk'

The word 'risk' is used in many different ways in the insurance marketplace and we need to look at each of these in turn. Here we will examine the term in its everyday sense and find our first problem. There is no universally recognised definition for the term risk.

A1 Risk perception

If you were to ask anyone what the term 'risk' means to them you are likely to receive a wide variety of answers – everything from the owner of the business being concerned about the possibility of recession to worried parents concerned about all kinds of dangers faced by their children. Yet others may identify the risks inherent in running a business – perhaps the demand for their products or obsolescence issues. The list of risks that we face in everyday life is almost endless.

In a personal sense, we all take decisions based upon an assessment of risk, albeit that it is usually carried out informally. We assess the likelihood of rain occurring and decide whether to take an umbrella when we leave home in the morning. There may be some data involved (a weather forecast) or we may have merely looked out of the window to make a judgment about the likelihood of rain. This informality may be acceptable in 'low risk' situations where the ultimate calamity is something like wet clothing, but in many contexts, we need better measurement tools, especially where the potential for loss is significant.

Risk measurement and the means of attempting to deal with the risks we face are collectively termed risk management

Risk measurement and the means of attempting to deal with the risks we face are collectively termed **risk management**. In a commercial context, this is often a well-defined and scientific process, attempting to answer questions such as 'How much will it cost if things go wrong?' and 'What are the chances of the risk becoming a reality?' We will deal with these issues in greater detail later in the study text. In a personal sense, most individuals make less precise calculations, often preferring instead simply to protect against those things that seem capable of inflicting some kind of financial disaster, such as fire or theft.

We begin by considering just what is meant by the term 'risk'.

A2 Definition of risk

Consider the following statements, each giving a different slant to the term 'risk':

- possibility of something unfortunate happening;
- doubt concerning how something will turn out;
- unpredictability;
- possibility of a loss; and
- chance that there might be a gain (the horse you backed might win).

Whichever choice we make (umbrella or no umbrella for example), we need to recognise the elements of uncertainty and unpredictability or, in some cases, danger. The term often implies something that we do not want to happen.

Types of risk that can be insured are covered in section E

Consider for example the many risks associated with owning a building. These include the risk that:

- the building might be damaged by fire or flood;
- someone working in or visiting the building might get injured; or
- someone else's property might get damaged either by parts of the building falling on it or whilst being stored in the building.

Each of these represents a risk so far as the owner is concerned and in each case it is possible to insure (transfer) the risk. This is done by the owner paying a known premium to an insurer in return for the insurer accepting the future unknown cost of the insured risk. The insurer does this by promising to pay for loss, damage or liability as defined by the policy terms. Insurance, therefore, is a means of transferring the risk.

Insurance is a risk transfer mechanism

The acceptance of an unknown future potential risk by an insurer for an agreed premium is a way of defining insurance as a **risk transfer mechanism**. It brings peace of mind to the insured because they have replaced the uncertainty of possible future loss with the certainty of the agreed premium. We consider this aspect later in the chapter in section H.

Activity

If you were the owner of the building in which your office is located, consider all the bad things that could happen – what might go wrong?

A3 Other meanings of the term 'risk'

There are three other ways in which the term is used in the insurance marketplace:

- peril being insured (e.g. fire or collision);
- subject-matter of insurance (e.g. the factory, ship or potential liability); and
- the thing insured, such as the property itself, and the range of contingencies or scope of cover required (if the term is used by an insurer, they often mean both of these).

A4 Attitude to risk

People are either risk-seeking or risk-averse

Each person's attitude to risk is different. Therefore, we all respond to risk in a different way. Some people are willing to carry certain risks themselves and are termed **risk-seeking**, while others lean more towards being **risk-averse**, feeling happier minimising the risk to which they are exposed. (Perhaps by transferring the risk by means of insurance – see section H.) Very few individuals are in a position to evaluate, with any accuracy, the risks to which they are exposed. However, many companies attempt to achieve this as part of their risk management process.

Consider this…

What is your personal view of risk – do you consider yourself to be risk-averse or risk-seeking? Will you go out without an umbrella?

Does your view change if the risk involves any potential financial loss aspects?

Question 1.1

Which of these terms describes an individual who is keen to remove risk where possible?

a. Risk unhappy ☐

b. Risk-averse ☐

c. Risk-seeking ☐

d. Risk confident ☐

B Risk management

The appointment of risk managers in industry and commerce is now commonplace

There is a continuing trend towards taking control and developing a formal strategy for managing the various risks that affect businesses. The appointment of risk managers in industry and commerce is now commonplace. Many are members of the Association of Insurance Risk Managers. This organisation shortened its name by the omission of the words 'in Industry and Commerce' but has kept its old acronym of AIRMIC.

Useful website

See www.airmic.com

Risk management is important for a number of reasons:

- It reduces the potential for loss
- It gives shareholders confidence that the business is being run properly*
- It provides a disciplined approach to quantifying risk

*For companies quoted on the stock market there is a legal requirement to identify all significant risks to which the business is exposed and to explain in the annual report how these are being managed.

The decision to transfer risks (for example, by insurance) is an important final stage in the risk management process.

When it comes to general insurance, risk management is a significantly different concept for individuals than it is for businesses. Many individuals, when they consider their own financial planning, personal protection and wealth management issues, tend to adopt a formalised approach – often facilitated by a financial adviser. The decision-making process involves the completion of a detailed 'fact-find' and an equally detailed consideration of their income, savings, assets, health and future aspirations.

However, the issue of personal general insurance does not very often follow this detailed process. Often it is not bought as the result of a carefully made decision that insurance is the best solution to a particular financial problem. Instead, it is bought because certain elements of cover may be compulsory, such as third party motor insurance, which the law requires everyone to have (see section J for more information). Alternatively, it may be that another party has a financial interest in the item to be insured; for example, a homeowner's mortgagee (such as a bank) who will insist upon insurance being effected.

Of course, there are areas where there is real choice as to whether to insure or manage the risk in some other way. However, even here it is highly unlikely that a scientific approach will be taken to assessing risk. The most dominant factor is likely to be an individual's risk appetite or an inability to afford insurance protection.

Individuals with very substantial physical assets may adopt a more formalised system

Individuals with very substantial physical assets may adopt a more formalised system. These types of policyholders are often termed 'high net worth' individuals and certain insurance products have been developed specifically for them.

Activity

Conduct a poll of your colleagues, family or friends in relation to their motor insurance. How many of them have fully comprehensive insurance as opposed to the legal minimum of third party insurance? Ask them why they have more insurance than the law requires and how they came to make their purchasing decision.

Is there any pattern in their answers?

B1 Function of risk management

Risk management may be defined as: **'The identification, analysis and economic control of those risks which can threaten the assets or earning capacity of an enterprise.'**

The focus of good risk management is the identification and treatment of defined risks. Risk management should be a continuous and developing process embedded in a firm's strategy.

The focus of good risk management is the identification and treatment of defined risks

It should address methodically all the risks surrounding the firm's current, past and future activities. This definition identifies the three steps involved in managing the risk, namely:

identification → analysis → control

Let us look at these in more detail. Think of risk as the bad things that could happen.

B1A Risk identification

This step involves the company discovering its possible existing and potential future threats. Not all of these risks will be insurable, but they must all be managed.

For example, in the case of a retail shop, petty theft and shoplifting may be real risks and will need to be managed in some way or funding set aside to cover their costs.

For many conventional risks, an insurer may become involved in helping to identify existing and potential risks through carrying out a physical examination or survey. Insurers also play a role in relation to risk control when they provide reports following the survey. Even if the risk is not ultimately insured, the client still has the benefit of the insurer's advice concerning the risk.

B1B Risk analysis

Risk managers examine past data to evaluate or analyse the risk. For example, they can look at the past loss patterns of, say, hurricanes on the east coast of the USA, and so predict likely losses in the future.

Insurers will look at many of the same elements when considering the rating of a risk.

B1C Risk control

If the risk is seen to have the potential for adverse consequences, some course of action should be put in place to control, reduce or even eliminate the risk. Elimination is the most effective, but may be costly or impracticable.

Risk elimination is the most effective but may be costly or impracticable

For example, if a manufacturer carries out some paint-spraying. This activity has the following risks (not a complete list):

- Spraying other items because the area has not been sealed and the paint has moved in the wind perhaps onto other people's property.
- Employees becoming ill because they have breathed in paint vapours.

The manufacturer has the choice not to perform the process altogether and in so doing eliminate that element of the risk.

Alternatively, they can analyse, assess and manage the risk to prevent or minimise the occurrence of any adverse things.

This analysis should consider:

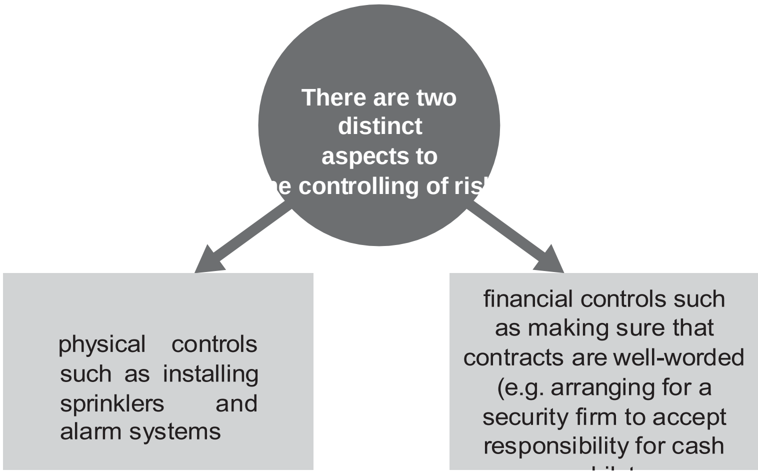
- First, what is the likelihood of the risk actually happening – using, for example, a scale of 1–3, with 3 being the most likely.
- Secondly, considering the likely impact on the same scale of 1–3.

These two numbers can then be multiplied allowing the business to rank in order the risks it faces. This allows the business to undertake any analysis of the costs of minimising or mitigating losses.

A typical cost cost-based analysis using our scenario above is, for example, how much does it cost to enclose entirely the spraying area to prevent over-spray? Is the multiplier of likelihood X impact serious enough to warrant this expense? Does it make more practical sense to have the spraying done by another organisation?

The elimination of risk, or even its reduction, will always be subject to the test of whether the cost of doing so is reasonable compared to the cost of the feared event happening.

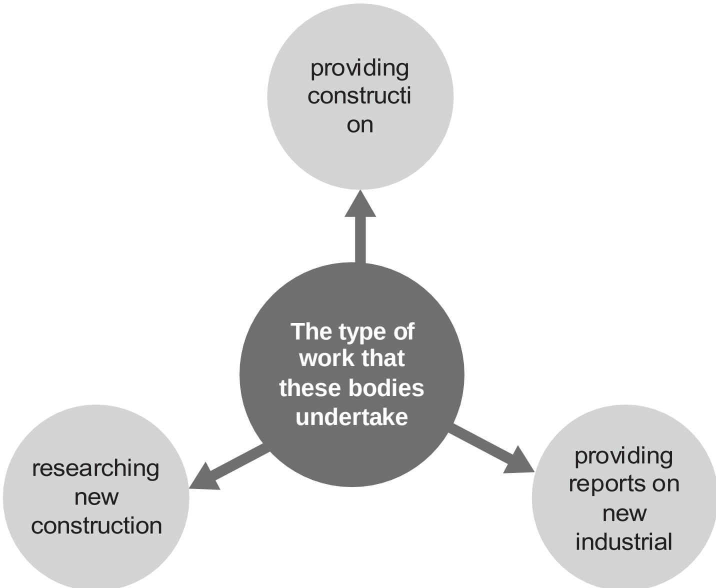
Two distinct aspects to the controlling of risk: physical and financial



Insurers (and to an increasing degree, insurance brokers) assist in the area of loss prevention and control. They do so by imposing requirements and making recommendations designed to improve the risk, following the completion of a survey. These are important parts of the pre-risk surveyor's report and are aimed at either improving the risk to an acceptable standard from the insurer's point of view, or offer premium reduction as an incentive for worthwhile risk improvements.

In a wider context, insurers are involved in researching areas of loss prevention and control.

Much of the work was carried out on their behalf by the former **Loss Prevention Council** (**LPC**), which now forms part of the **Building Research Establishment (BRE)**, and the **Fire Protection Association** (**FPA**).



Insurers must strive constantly to ensure that their knowledge of their potential clients' businesses remains up-to-date, whether that is in relation to new types of building construction, the further development of offshore drilling technology or the law changing so as to extend potential liabilities.

Activity

Think about how building construction has changed in the last few years – look around you and see the different materials that are going into modern building construction. How do you think this affects the risks presented by clients to insurers?

Use this link to access guidance provided by the Fire Protection Association: www.thefpa.co.uk/advice--guidance/

Question 1.2

A factory installing sprinklers into its premises is an example of which activity?

a. Risk transfer ☐
b. Risk modelling ☐
c. Risk control ☐
d. Risk analysis ☐

C Components of risk

In order to gain a deeper understanding of the meaning of risk, we need to take a closer look at the various components of risk.

These include:

- uncertainty
- level of risk
- peril and hazard

C1 Uncertainty

The concept of uncertainty implies doubt about the future

The concept of uncertainty implies doubt about the future, as a result of our incomplete ability to predict what is going to happen. If we could say with certainty what was going to happen, there would be no element of risk involved. If we know that our factory will burn down at 4pm tomorrow, or that on the way home we will have a car accident, there is no risk of the event happening, as the event would become a **certainty**. As we do not have this prior knowledge, we can say that we live in an uncertain or risky environment and that risk exists separately from the individual.

Even in the context of life assurance there is uncertainty. We know that we will all die one day but we do not know when.

C2 Level of risk

The second aspect of risk relates to the different levels of risk that exist

The second aspect of risk relates to the different levels of risk that exist. We know that there is a greater likelihood of some things happening than others and this is what we mean by the level of risk involved. Risk is usually assessed in terms of:

- **frequency** – how often it will happen; and
- **severity** – how serious it will be if it does happen.

These are the measurement criteria used in the risk management process. We'll now examine them in turn.

C2A Frequency

Imagine a building situated by the side of a river which is known to be prone to overflowing its banks. This situation involves risk. There is some doubt as to the future outcome because it is uncertain whether the river will ever overflow and if it does, when this will happen. The fact that the river is prone to overflowing increases the chance that damage will occur.

Imagine a second building which is 100 metres away from the river bank and on a slight hill. This building will be less at risk from flooding because of its position.

C2B Severity

Our judgment as to the level of risk posed may change if we consider the potential amount of loss, damage or destruction. For example, if the first building close to the river is valued at £90,000 and the second building, further away, is valued at £250,000, we might modify our view as to which building represents the higher risk, in view of the higher potential severity of loss.

Consider this…

What is your common sense view of which building is potentially safer from the flooding risk?

The relationship between frequency and severity varies from one risk to another

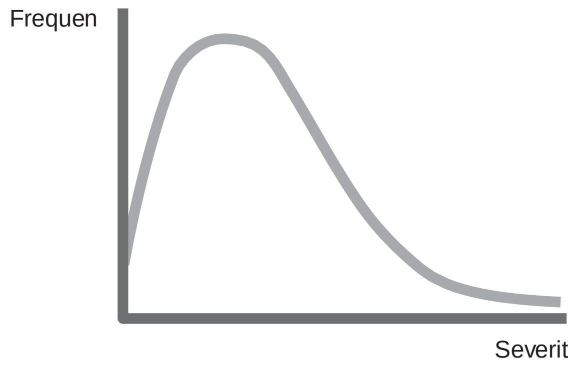
Therefore, factors relating to both frequency and severity must be taken into account in our assessment of risk. The relationship between frequency and severity varies from one risk to another.

High frequency and low severity

In a large number of different risk situations, there is a high frequency and low severity of loss. What this means is that there are lots of small losses, such as car crashes but none of them cost very much to repair. This is illustrated in Figure 1.1.

This could relate to comprehensive private car policies, where there are many losses for damage to the insured's own vehicle which are low in value, but relatively few third party personal injury claims which will be far higher in value.

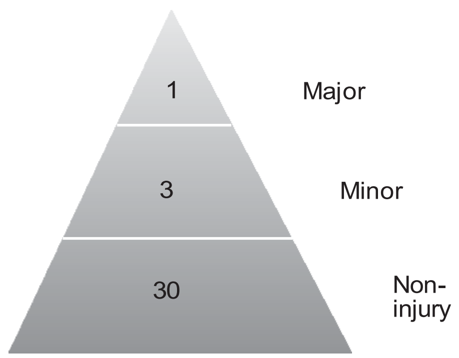
Figure 1.1: High frequency and low severity losses



This relationship between high frequency and low severity losses is not limited to a single type of insurance or a single type of loss. In fact, research into industrial injury incidents has shown a very similar pattern.

The Heinrich Triangle, developed in 1931 (see Figure 1.2), shows that, at that time, for every one major injury at work, there were 30 minor ones and 300 non-injury incidents. The triangle was created as the result of looking at several thousand incidents at work and similar studies have given similar results. The pattern shows few serious incidents and very few minor ones.

Figure 1.2: The Heinrich Triangle



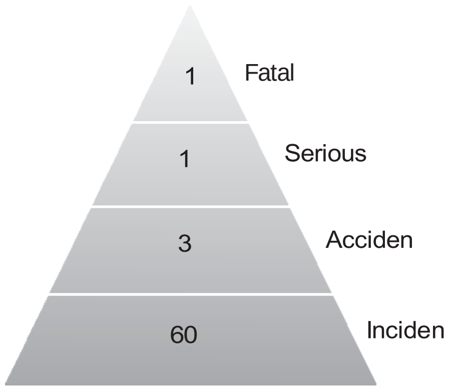
Similar research has been carried out in the area of motor accidents (in 1969 by Frank E. Bird who worked at the time for the Insurance Company of North America) using the statistics from two million accidents and near misses. Critically from an insurer's perspective, the relationship between serious and minor incidents is an important one, as we shall see.

He found that the split was more subtle than that identified by Heinrich and came up with his version of the triangle as illustrated in Figure 1.3.

Activity

If you are interested in reading more about Bird's work, use an internet search engine to look for this book: Bird Frank E., Germain George L., *Loss Control Management: Practical Loss Control Leadership*, Revised Edition, Det Norske Veritas (USA), Inc.

Figure 1.3: Frank E. Bird's Triangle



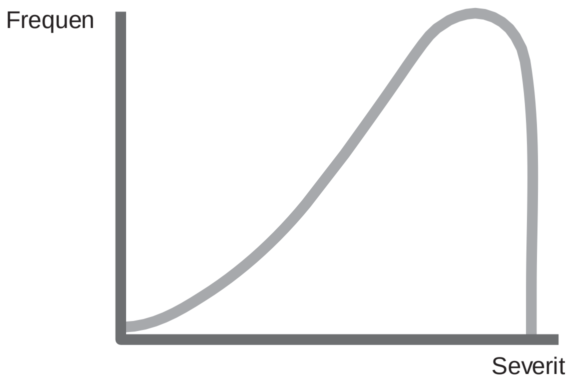
Low frequency and high severity

In some cases there is a low frequency and high severity of loss. This is illustrated in Figure 1.4.

In some cases there is a low frequency and high severity of loss

In this case, a small number of events would result in very high costs. Accidents involving aircraft are good examples of this type of risk profile because, when a loss occurs, the cost could be substantial. However, technological advance helps to reduce the frequency of accidents.

Figure 1.4: Low frequency and high severity



Activity

Look at this website and see how the aviation industry is trying to understand and control risk and hazard.

www.caa.co.uk/Safety-initiatives-and-resources/Working-with-industry/Bowtie/Bowtie-elements/Hazard/

Significance of frequency and severity

The different frequency and severity profiles are important to insurers. This is because they wish their businesses to be, as far as possible, free from great peaks and troughs in relation to claim payments made from one year to the next. Smooth trends in trading patterns tend to encourage investors to support an insurer.

An insurer often bases its decisions on how much of a risk it can prudently accept on factors relating to frequency and severity. Insurers have various ways of dealing with a risk that is offered to them where the amount involved exceeds their normal acceptance limits. We will review this further in chapter 3 on reinsurance.

An insurer often bases its decisions on how much of a risk it can prudently accept on factors relating to frequency and severity

A key reason for an insurer to be able to predict the frequency and severity of losses is to forward plan in order to be able to respond to infrequent large catastrophe-type claims. It is also important that an insurer can calculate its financial exposure to risks; this subject is reviewed further in study text *LM2: London Market insurance principles and practice*.

?

Question 1.3

An aviation insurer does not expect many losses in a year but knows that they are likely to be of a high value when they do occur. Which of these describes this pattern of losses?

a. High frequency and high severity ☐
b. Low frequency and high severity ☐
c. High frequency and low severity ☐
d. Low frequency and low severity ☐

D Categories of risk

Not every type of risk or eventuality is insurable

It does not follow that, having identified a risk, it will automatically be insurable. Not every type of risk or eventuality is insurable. It will help our understanding if we look at (and contrast) different types of risk to identify those that are insurable and those that are not. The groupings that we will look at are:

- financial and non-financial risks;
- pure and speculative risks; and
- particular and fundamental risks.

D1 Financial and non-financial risks

Some of the risks that we face are not capable of financial measurement

Some of the risks that we face are not capable of financial measurement. They may have a financial aspect to them, but it is incidental. The real risk arises from decisions and actions motivated by other considerations. Take for example the choice of a marriage partner or our enjoyment of a holiday.

We cannot measure these in financial terms. In the same way, the value we might place on an heirloom that has been in the family for years, may be far beyond its intrinsic or market value. Insurance is not appropriate for such risks. The heirloom could indeed be insured but only for its market value, not for the sentimental value we place on it.

For a risk to be insurable the outcome of adverse events must be capable of measurement in financial terms. Most general insurances are compensatory in nature, as we shall see later. This means that the value placed on the loss is not determined in advance.

Important exceptions to this general rule are personal accident and sickness policies that we will touch on in chapter 2. This is because there is no way of valuing precisely the loss of a life or the loss of sight so these policies are taken out in order to provide pre-agreed amounts in the event of an accident or sickness and are known as **benefit policies**. Similar considerations apply to life assurance policies.

Let us look at some examples of financial risks to help us understand this concept:

Loss	What is insurable?
Accidental damage to a motor car	The financial value of the risk is the cost of repairing or replacing the vehicle.
Theft of property	The financial value of the risk of theft of an item of jewellery is its current market value. This is measurable in financial terms. It would not include sentimental value because, as we have seen, this is not precisely measurable in financial terms.
Loss of business profits following a fire	This risk is measurable since comparisons can be made to similar trading periods to devise a fair estimate of the loss to be paid by the insurer as compensation.
Legal liability to pay compensation for personal injury to others	The courts measure the value of damages applicable for the loss of a leg, for example, against compensation payments made previously by the courts. The courts calculate damages that will take account of financial circumstances as well as the injury itself, for example covered future medical payments or special equipment.

D2 Pure and speculative risks

There are many situations in life when we speculate with a view to making some kind of gain.

Obvious examples are the National Lottery or other forms of gambling. There are also situations such as investing in the stock market or starting up a new business that fall into this category, as well as pricing decisions and other aspects of marketing. With each activity we aim to make a gain, but each carries the possibility of break-even or failure. Consequently, although there are some aspects of business activity that can be insured, this does not include things such as misreading the market or a business failing because of local competition. These are called speculative risks and they cannot be insured.

Examples of speculative risks are the National Lottery or other forms of gambling

Pure risks, on the other hand, are those where there is the possibility of a loss but not of gain, and where the best that we can achieve is a break-even situation. Travelling in an aircraft is a good example. The best that we can hope for is a safe arrival. The possibility exists however, that there might be an accident and the aircraft damaged or someone injured. It is these types of risk that are generally insurable.

You may have already thought of these, but here are some examples of pure risks:

Pure risk	Information
Risk of fire	This could damage or destroy property or cause an interruption to the running of the business, both risks are measurable in financial terms.
Risk of machinery breakdown	This could lead to actual damage or business interruption and is measurable in financial terms.
Risk of injury to employees at work	If such injury is caused by the negligence of the company, a court may award damages and costs. These risks are measurable in financial terms.

Consider this…

If you decide to abandon your career in insurance and become a fashion designer – you can insure the pure risks associated with your workshop and equipment, but you cannot insure against the risk of your first collection being a disaster – this would be speculative risk.

D3 Particular and fundamental risks

There are some risks that occur on such a vast scale that they are uninsurable. These are called **fundamental risks**. Take for example the risk of famine, economic recession or a more general risk – that of war.

There are some risks that occur on such a vast scale that they are uninsurable

Fundamental risks can be defined as those that arise from social, economic, political or natural causes and are widespread in their effect. As we have seen, non-financial or speculative risks are uninsurable as a matter of principle. In contrast, the problem with fundamental risks is that it is often a lack of willingness or capacity on the part of insurers that causes such risks to be difficult to insure or even completely uninsurable.

It is not an easily defined category and there seem to be, on the face of it, many exceptions to the general rule, particularly in the London Market. Just think of the fact that marine insurers will often grant war risks cover for vessels and cargo, or even the fact it is possible to be insured for earthquake cover in California. Nevertheless, the fact remains that those risks that tend to affect whole countries, regions or communities are classified as fundamental and therefore generally difficult to obtain insurance for in the commercial market.

Fundamental risks

Two risks automatically categorised in this way for non-marine policies are **war risks** and **nuclear risks**.

Reinforce

Think about some of the widespread natural disasters, wars and economic recessions of the past 15 years. What might the claims impact have been on the insurance industry?

Activity

Visit the Sigma website – www.swissre.com/sigma/

Read the latest report concerning catastrophe losses and see how many of them might fall into this category of fundamental risk. With how many of the catastrophes listed was your organisation involved?

In contrast to fundamental risks, particular risks are localised or even personal in their cause and effect

In contrast to fundamental risks, **particular risks** are localised or even personal in their cause and effect. Sometimes the cause may be more widespread (a storm over a whole region), but the effect is localised or even related to an individual. For example, not all properties in the region will have been damaged.

Let's look at some examples of particular risks:

Particular risk	Information
Factory fire	This would cause localised damage to the factory and possibly to its surroundings, but would not affect the whole community.
Car collision	Damage to the vehicles and any third party liability are localised events affecting relatively few individuals.
Theft of personal possessions from a home	An event that only affects an individual or family.

We have established that only certain classifications of risk are insurable: those that are financial, pure and particular. There are certain other things that need to be in place for a risk to be insurable – which we'll examine in the next section.

?

Question 1.4

Why is the chance of winning the lottery uninsurable?

a. The underwriter cannot calculate the chance of it happening to quote a premium ☐
b. You cannot insure risks where there is a chance of making a gain ☐
c. It is against public policy ☐
d. The National Lottery organisers have their own insurance ☐

E Types of risk that can be insured

As we have just seen, not every risk is insurable. In addition to being financial, pure and (generally speaking) particular, the following features must also apply for a risk to be insurable:

- a fortuitous event;
- insurable interest;
- the risk itself must not be against public policy; and
- the risk must generally not be a one-off.

E1 Fortuitous event

To be insurable, the happening of the event must be fortuitous

To be insurable, the happening of the event must be fortuitous. In other words, it must be **accidental or unexpected and not inevitable**, for the insured. It must certainly not be deliberate on the part of the insured. An example of a non-fortuitous loss is an insured setting fire to their property. In contrast however, a theft may have required careful planning by the thieves, but still be unexpected for the insured.

E2 Insurable interest

Insurable interest is the legally recognised financial relationship between the insured and the object or liability that is being insured. For example, you can insure against the theft of your own car, because you suffer financial loss if it is stolen, but your neighbour cannot insure your car as they will not suffer financially if anything happens to it.

Other examples of insurable interest, not necessarily based on ownership would be:

- Having responsibility for someone else's goods because they are stored in your warehouse.
- Having responsibility for maintaining the pavements, where you might have a legal liability should anyone fall over and damage themselves.

Activity
Make a note of the various ways you might think insurable interest can arise; then refer to your notes when you study chapter 2.

E3 Public policy

Insurers should not cover risks that are against public policy

It is commonly recognised in law that contracts must not be against public policy or go against what society considers to be the right or moral thing to do. Insurers should not, therefore, cover risks that are against public policy.

For example, it would be against public policy to insure the risk of incurring a fine for a criminal offence. The risk may appear to have all the features of an insurable risk, as the event may be considered fortuitous (accidental) and the insured has an insurable interest, since they suffer financial loss as a result of the fine. However, it is clearly unacceptable to be able to insure against paying a fine, because the purpose of the fine is to punish the individual. Providing insurance for this type of risk may encourage people to break the law.

Insurance cover for fines
You may see coverage for fines in some insurance policies that you review. This will be for administrative fines rather than criminal fines – an example of this might be a fine imposed by the customs officials at a port if shipping paperwork is not completed properly.

Before we move on to consider the pooling of risks, let's consider the importance of homogeneous (similar risks) exposures to insurers, as contrasted with one-off risks.

E4 Homogeneous exposures

A sufficient number of exposures to similar risks, historical patterns and trends will enable an insurer to forecast the expected extent of future losses. We could call such risks 'objective risks'.

In the absence of a large number of homogeneous exposures (i.e. similar risks) the task is harder, as a pattern is more difficult to determine. In extreme cases where there is no historical data, the risk becomes a subjective one from an insurer's point of view.

The concept of homogeneous exposures is an ideal

Whereas fortuitous loss, insurable interest and not being against public interest are absolute requirements, the concept of homogeneous exposures is an ideal. There are occasions when an insurer will need to use less than fully reliable historical data when fixing premiums, such as:

- a completely new risk (such as new technology); and
- risks in parts of the world not previously open to that insurer.

For example, insurance is available for satellite launches, even though instances of such launches are fairly infrequent and any failure generally catastrophic. However, wherever possible, an insurer looks for homogeneous exposures in order to utilise as fully as possible the law of large numbers. The greater the number of similar risks to insure, the closer the actual outcome will be to what was expected in terms of losses.

Activity
Visit www.lloyds.com and find examples of the London Market insuring famous people's body parts. Consider how the insurers work out the risks and the premium to charge.

Summary of insurable and uninsurable risks

From what we have seen in the preceding sections, the risks that are generally insurable and those that are not can be summarised as follows:

Insurable	Uninsurable
Financial	Non-financial
Pure	Speculative
Particular	Fundamental (generally)
Fortuitous event	Deliberate act
Insurable interest	No insurable interest
Not against public policy	Against the public interest
Homogeneous exposures	One-offs (generally)

Question 1.5

What does the term 'homogeneous exposures' mean?

a. Underwriters have never seen anything similar before ☐

b. Underwriters have some historic data to work from ☐

c. The risks are similar to those seen before ☐

d. The risks are all from the same geographic location ☐

F Pooling of risk

The basic concept of insurance is that the losses of the few who suffer misfortune are met by the contributions of the many, who are exposed to similar potential loss. An insurer gathers together relatively small individual sums of money from people who want to be protected financially from similar kinds of perils. The insurer sets itself up to operate a pool. In fact, as we shall see, insurers operate a number of separate pools for each different class of insurance they underwrite.

Contributions, in the form of premiums from many insureds, go into this pool. From the pool, payments are made to compensate the losses of the few.

The premiums must be large enough, in total, to meet the losses in any one year

The premiums must be large enough, in total, to meet the losses in any one year. In addition, they should cover the costs of operating the pool and provide an element of profit for the insurer. The insurer endeavours to make sure that the premium paid by the insured is **proportionate to the risk which they introduce to the pool**.

Balancing the books for an insurer

The basic business equation that the insurer has to balance is premium ? claims + operating costs.

In words, the premium has to be greater than or equal to the total of claims and operating costs.

F1 Law of large numbers

In operating the pool, insurers benefit from the law of large numbers

In operating the pool, insurers benefit from the law of large numbers. This states that where there are a large number of similar situations, the actual number of events occurring tends towards the expected number.

The law of large numbers can be illustrated by considering the flip of a coin, which can result in a head or a tail combination. On the simple mathematics of the situation, you would expect to get the same number of heads and tails, because the chance of getting either is 50%. However, flipping the coin just 20 times may not give us the 50/50 split we would expect.

Flipping the coin 10,000 times, we would almost certainly see a result of approximately 5,000 heads and 5,000 tails. The law of large numbers, therefore, operates to give a result which is in keeping with the underlying probability (likelihood of something happening) of, in this example, 50% heads and 50% tails.

Applying the principle of large numbers to insurance enables the insurer to predict fairly confidently the final cost of claims in any one year. This is because insurers provide cover against a large number of similar risks, and the final number of actual loss events tends to be very close to the expected number – provided the conditions under which the original data were gathered remain constant. This enables the insurer to calculate likely losses and so confidently charge a fixed premium.

In addition to the law of large numbers, the insurer also uses historic data to predict the pattern of claims payments and ultimate claims values. Obviously, this historic data is of limited use when the insurer moves into new classes of business; in this case, the law of large numbers becomes more of a key tool for calculating likely losses.

F2 Equitable premiums

To operate a pooling system successfully, a number of pools must be set up – one for each main group of risks being underwritten. For example, an individual pool for, say, marine or aviation hull insurance and another for property insurance must be set up.

Marine and aviation hull insurance

Marine or aviation hull insurance is insurance against physical damage to a ship or an aircraft. For more about classes of business see chapter 3.

Each insured wishing to join the pool must be prepared to make an equitable (fair) contribution to that pool.

Each insured wishing to join the pool must be prepared to make an equitable (fair) contribution to that pool

When deciding on an equitable contribution, insurers take into account the different elements of risk brought into the pool by each of the insureds. These are often referred to as discrimination factors. Arriving at a premium is a complex process and the correct assessment of risk is extremely important. This will ensure that a fair premium is charged, that also allows for cost-covering and profit-making. This is the task of an underwriter when considering an individual risk.

Premium calculation is covered in more detail in study text *LM2*.

G Peril and hazard

Let's start with a brief definition for both peril and hazard:

Peril	can be defined as that which gives rise to a loss, i.e. fire or flood.
Hazard	can be defined as that which influences the operation or effect of the peril.

Consider this...

Consider a factory insured against fire which has no sprinklers installed.

If a fire breaks out - that is the **peril**. The lack of sprinklers is a **hazard** in this scenario as it has the potential to make the fire cause more damage than it otherwise would.

Here are some other examples of peril:

Explosion	this is the event insured against, which may give rise to loss.
Lightning	when it occurs, this natural peril can result in damage.
Collision	whether between ships, aircraft, or vehicles.
Dishonesty	either employees or external parties stealing from a company for example.

G1 Physical and moral hazard

Physical hazard relates to the physical characteristics of the risk

Physical hazard relates to the physical characteristics of the risk and includes any measurable dimension of the risk. Examples include the following:

Security protection at a shop	the greater the security protection, the better the physical hazard.
The construction of the property	the higher the standard of building construction the less likely it is that it will suffer damage. These standards can apply to both the materials used and the building process itself.
Age of a proposer and type of car for motor insurance	these are factual, measurable dimensions.

Moral hazard arises from the attitude and behaviour of people

Moral hazard arises from the attitude and behaviour of people. In insurance, this is usually the conduct of the insured. Moral hazard also arises from the conduct of the insured's employees and that of society as a whole. For example:

Carelessness	a driver's lack of care can increase the chance of an accident happening and its severity.
Dishonesty	a person who has previously made fraudulent or exaggerated claims represents a poor moral hazard.
Social attitudes	a person who regards insurance fraud as acceptable and not immoral.

The way in which a business is run is an example of moral hazard

The way in which a business is run is also an example of moral hazard. For example, careless or lax management in a factory represents poor moral hazard. This is clearly something relating to attitude and behaviour, but it may be evident because of unguarded machinery or a lack of control of smoking by employees, for example.

It is unsafe to jump to the conclusion that there is an adverse moral aspect to a risk, merely because the risk is an obviously heavy one. For example, a fireworks factory represents a very heavy fire risk, but it does not follow that there is a poor moral aspect to the risk. The safety and security within the factory may be world class, and therefore the hazard is low and mitigates the apparent size of the risk.

Equally, a young driver who is driving a high-performance car certainly represents a poor moral hazard on the face of it as the statistics show that a large proportion of car accidents are caused by young drivers. The car itself will be in a high rating group because of its value and performance. These two aspects are physical because they are measurable. It is, of course, important to factor into the equation other key information such as the proposer's loss history and any serious motoring convictions.

Looking again at some of the perils identified above, some of the hazards which can be linked with them are:

Explosion	this is the event insured against, which may give rise to loss. The hazards that might be linked with this are the storage of dangerous chemicals or not ensuring that there is no smoking in certain areas.
Lightning	when it occurs, this natural peril can result in damage. Hazards would be the construction of any buildings struck by the lightning or the inadequacy of any lightning conductors being used.
Collision	whether between ships, aircraft, or vehicles. The hazards are in relation to speed, behaviour, extent of training for example. Having a relaxed attitude to the speed limit as a driver is an example of bad moral hazard.
Dishonesty	either employees or external parties stealing from a company for example. The hazards are things like poor security in place or inadequate operational controls. A lax corporate attitude to security is an example of bad moral hazard.

?

Question 1.6

A factory manufacturing fireworks is inspected by insurers and found to have excellent safety protocols and good training for the staff. What are the protocols and training examples of?

a. Good moral hazard ☐
b. Poor moral hazard ☐
c. Good physical hazard ☐
d. Poor physical hazard ☐

H Reasons for buying insurance

The need for insurance

Why bother? Whether an individual (or a business) wants some form of insurance depends on their attitude to their potential risk, what price they are prepared to pay for the peace of mind which insurance gives and the extent to which they feel they have a choice about insuring the risk.

Insurance has been meeting this need for a very long time. It has its origins in the different kinds of situation where financial protection is required against the possibility of suffering some misfortune or loss.

But how is peace of mind achieved? As we have seen, the primary function of insurance is to act as a risk transfer mechanism between the insured and the insurer but of course the transfer of risk does not prevent the bad things from happening, but it provides a form of financial security and peace of mind for the insured.

For example, the large unknown financial risk that a company faces of their factory burning down is transferred to the insurer and replaced by the much smaller and certain cost of the premium.

I Primary and secondary functions of insurance

Benefits of insurance

Insurance brings many benefits to policyholders and to society as a whole.

Insurance brings many benefits to policyholders and to society as a whole

The primary functions of insurance are:	**Spreading the risk.** By transferring the risk to insurers and by insurers then sharing the risk between themselves either as co-insurance or reinsurance the risk is spread far wider than it would be if it was retained by the insured.
	To provide a degree of certainty. In exchange for the premium, and subject to any limitations in the insurance itself, the insured swaps the uncertainty of loss for the relative certainty provided by the insurance protection.
	To transfer risk. Individuals and organisations should consider the risks that they are exposed to and decide whether they can eliminate them altogether, whether they can be mitigated to an acceptable level or whether they can be transferred. In exchange for a modest premium, the insurers will accept the financial risk being transferred to them thus providing the peace of mind for the insured, whether a large corporation or an individual.
The secondary functions of insurance can be described as:	**Companies do not have to set aside large sums of money** as 'safety nets' for dealing with losses. Without insurance, large sums would need to be built up and set aside to cater for unforeseen contingencies, such as fire, flood or liabilities.
	Companies can be confident to look to expand their business. Without insurance, if they are acting prudently, they should be putting funds aside for the ultimate 'rainy day'. With insurance, they are still vulnerable to loss but it is not their funds at risk and this may encourage an entrepreneurial approach in, say, opening up a factory or launching a new product. Insurance provides security from which to develop such innovations.
	Jobs are protected. If there is a fire in a factory then there will be physical damage. But often it does not stop there and there are other consequences. If the factory is the only one that the insured owns, then their business may well grind to a halt until the factory can be rebuilt, unless they can find alternative premises in a hurry.
	Losses are reduced in size and number – this might sound odd when we have previously said that insurance does not stop the bad things happening but insured risks will generally have the benefit of risk management from the insurers (if not performed by the insured themselves) as the larger risks will be surveyed. This can identify areas for risk improvement and loss prevention.
	Insurers are largely investors of funds – benefiting the economy. Firstly, there is a time delay between the receipt of premiums and the occurrence of claims. This creates a premium reserve. Once claims have occurred there is a further period (that can be very extensive for third party claims involving personal injury or illness) before the claims are actually paid. This element is a claims reserve.
	'Invisible' exports – only about 25% of the business written in the London Market is from UK-based insureds hence the insurance exported from London results in a flow of money (premiums) into London thus assisting the financial position of UK PLC.

Invisible exports

Instead of exporting something physical (or visible) such as cars, or foodstuffs, invisible exports are made when services are sold and exported. The service in this case is insurance. Most of the business of the London Market is insuring risks overseas, for overseas clients, so the insurance is exported to those other countries.

Activity

Review the latest Lloyd's Annual Report which can be downloaded from www.lloyds.com/lloyds/investor-relations and see what it says in the opening pages about the geographic spread of business coming into the Lloyd's Market.

Compare it with the company market by looking at the International Underwriting Association (IUA) latest statistics report which can be found here: http://bit.ly/2x17nR6

Question 1.7

Which of these activities is a secondary function of insurance?

a. Risk transfer ☐

b. Peace of mind ☐

c. Ability to enhance the business ☐

d. Job satisfaction ☐

J Compulsory insurance

In section B, we touched briefly on the insurance that has to be purchased whether the insured wants to or not. The UK Government has legislated to make certain forms of insurance compulsory and the same is true in many countries around the world, although the categories that are compulsory differ from country to country.

In the UK, the Government acts as an insurer in its own right in providing certain benefits for individuals. These are important and include welfare benefits, unemployment benefits and retirement benefits. However, this will not be the case in every country. Many countries, for example, have a form of workers' compensation cover (giving fixed benefits), which is provided by the private sector rather than by the Government.

Internationally, there is considerable variation in the provision of health insurance by the Government or the private sector and in how these two sources are balanced.

UK Government has tended to make the insuring of certain risks compulsory through legislation

The UK Government has tended to make the insuring of certain risks – relating to legal liability or negligence – compulsory through legislation. The aim is to make sure that funds are available to compensate the innocent victims of many types of accident (though not all). Those made compulsory by law can be summarised as follows:

- **Private individuals**. Motor insurance and public liability insurance in respect of the ownership of dangerous wild animals and/or dangerous dogs are compulsory for private individuals.
- **Professions and businesses**. Motor insurance and employers' liability insurance are both compulsory for every business which uses motor vehicles on a road and has employees respectively.

Public liability insurance is also compulsory for specific trades and professions, including riding establishments. Solicitors and other professionals, including insurance intermediaries, must have professional indemnity insurance. Marine pollution liability insurance is compulsory, as is liability insurance for operators of nuclear reactors.

The main reasons why certain forms of insurance are compulsory are:

- **To provide funds for compensation.** The main objective of compulsory insurance is to provide means by which persons injured, or suffering loss, through the fault of others may receive compensation. There would be little point in awarding damages to someone if there were no funds to meet the award. Compulsory insurance ensures, as far as possible, that funds are available when damages are awarded by a court, even though the person who caused the injuries may lack the necessary financial resources.
- **In response to national concerns.** Apart from riding establishments, the areas where insurance has been made compulsory represent areas of greatest national concern.
- **Reputation of the profession.** Alongside the concept of national concern, compulsory insurances which will provide compensation also serve partially to protect the reputation of certain professions such as solicitors.

We will now look at the nature of and rules introduced by the insurances that are compulsory within the UK.

J1 Employers' liability insurance

The **Employers' Liability (Compulsory Insurance) Act 1969** made it compulsory for employers in Great Britain to effect employers' liability (EL) insurance. This insures employers against their liability to pay compensation to employees who sustain bodily injury or disease, arising out of and in the course of their employment.

There is a list of exemptions from this requirement, mainly relating to family members and government agencies. However, in practical terms most employers have to insure this risk. The minimum required limit of indemnity has been increased and now stands at £5m, although the insurance market provides £10m as standard. There is also a requirement for employers to display their EL certificates, provided by insurers, at each place of work.

Minimum required limit of indemnity has been increased and now stands at £5m

The Employers' Liability Tracing Office (ELTO) was set up in April 2011 replacing the previous voluntary Employers Liability code of practice tracing service that had existed since 1999. The database contains all new and renewed policies from 1 April 2011, together with any older policies that have had claims made on them or had been traced through the voluntary code. Insurers have to publish this information within 3 months (i.e. if a risk incepts on 1 January, the information must be with ELTO by April the same year).

With effect from April 2012, additional information also needed to be captured relating to subsidiary companies and employer reference numbers (ERN).

Set up to provide claimants and their representatives with quick and easy access to a database of Employers' Liability (EL) policies through an online enquiry facility, ELTO is designed to help find the insurer of their former employer where the claimant is suffering from a disease/injury caused at work. The use of unique reference numbers such as the ERN also assists with tracing businesses that are no longer in existence by the time a claim is actually made.

Whilst ELTO is a mechanism for tracing potential insurance cover, it is not itself a body that compensates and finding something on its database is no guarantee that the insurance will respond.

Activity

Find the EL certificate which should be prominently displayed in your office – check areas such as the staff room, kitchen or notice boards. Is it up to date? If you cannot find it there check your intranet as it can legally be stored electronically as well, as long as it is in a central area. Search for www.elto.org.uk to find out more about the Employers Liability Tracing Office.

J2 Motor insurance

The **Road Traffic Act 1988** (as amended) stipulates that it is illegal to cause or permit the use of a vehicle on a public road (extended now to include 'any other public place') unless an insurance policy is in force, covering third party property damage and third party bodily injury or death.

The EU has had a significant influence in the area of compulsory motor insurance

The EU has had a significant influence in the area of compulsory motor insurance.

This has been prompted by the nature of certain freedoms, relating to the movement of goods and people, which are at the heart of the **Treaty of Rome**. Although compulsory third party personal injury cover featured as part of UK law well before the first **EU Motor Insurance Directive** in 1972, many subsequent changes to UK law have been prompted by EU directives. Compulsory third party property damage cover and the requirement to be able to trace the insurer of a vehicle from its registration plate are two examples. The EU directives do not currently regulate comprehensive motor cover (i.e. cover for the insured car or driver) or get involved in the compensation regimes in individual countries.

J3 Public liability insurance: riding establishments

All proprietors of riding establishments must have public liability insurance

One of the provisions of the **Riding Establishments Act 1970** is that all proprietors of riding establishments must have public liability insurance.

The insurance must indemnify the insured against claims arising from the use of the insured's horses. This would include injuries sustained by both persons riding the horses and members of the public. The insurance must also indemnify the horse riders themselves against any liability they may incur for injury to members of the public, arising out of the hire or use of the proprietors' horses.

J4 Liability insurance: dangerous wild animals and/or dangerous dogs

Apart from motor insurance, the other forms of liability insurance which are compulsory for private individuals are in respect of the ownership of dangerous wild animals or dangerous dogs.

The nature and scope of such insurance is not defined in the **Dangerous Wild Animals Act 1976** or the **Dangerous Dogs Act 1991**. However, the local authority, which issues the appropriate licence, must be satisfied as to the adequacy of the insurance.

In general, insurers are not willing to issue a policy that would only cover the liability arising out of the ownership of the dangerous wild animal or dangerous dog. This is a very specific risk and given that the insurance would most likely only be purchased by owners of dogs who were concerned about their dogs' behaviour, the prospect of a claim is higher than it might be if all dog owners bought the policy.

Instead the insurer would probably only be prepared to insure the risk as an extension to another insurance policy held by the insured/owner. Such a policy could be the household policy, where it would be covered within the public liability section.

J5 Professional indemnity insurance

Professional indemnity (PI) insurance is compulsory for certain professions

Professional indemnity (PI) insurance is compulsory for certain professions. These include solicitors and others such as accountants and insurance intermediaries who are authorised by the FCA.

J5A Solicitors

The **Solicitors Act 1974**, as well as the Solicitors Regulation Authority Indemnity Insurance Rules, states that solicitors must hold professional indemnity insurance. This insurance must indemnify the solicitor against claims for financial loss suffered by clients as a result of the solicitor's professional negligence.

Consider this…

If you are given bad advice by a solicitor you may not realise it for some time, maybe years. You may want to make a claim against the solicitor at that point. They might be a small high street firm that could try to argue they have no money to pay you, but they should have PI insurance in place to deal with your claim.

J5B Insurance intermediaries

Insurance intermediaries authorised by the FCA must have PI insurance

Insurance intermediaries authorised by the FCA must have PI insurance. Appointed representatives and introducer appointed representatives are not required to have this form of insurance, since everything they do is undertaken on behalf of an insurer that is responsible for their actions. FCA rules require insurance intermediaries to hold liability insurance in respect of financial loss caused by their professional negligence up to substantial limits (approximately £1m, although FCA limits are actually expressed in euros).

Activity

If you work for an insurance intermediary, find out what your firm's PI policy covers.

K Insurance as a service industry

We have already looked at the fact that most insurance is not compulsory and that insurance is purchased to transfer the risk.

It is important to understand the role of insurance as a **service industry**. Customers, even for compulsory insurance will remember the service provided by their insurer; they can and will move their business depending on the experience that they have with the insurer.

The insurer 'experience' is generally centred on claims handling, as before a loss happens most insureds pay little or no attention to their policy. The concept of the claims experience is as important in commercial insurances as with personal lines insurance; although the buyer of commercial insurances may be more sophisticated about the claims process and need less 'hand-holding' they will have equally high expectations as to service – perhaps higher.

Claims handling is discussed in more detail in study text *LM2*; however, a brief overview is provided here (covering the key aspects that an insurer should consider in relation to the service that is being provided to customers, individual or commercial).

K1 Claims personnel

An efficient claims department, staffed by competent and professional claims personnel, is vital to ensure the proper use of an insurance company's financial resources. The role of claims personnel is to:

An efficient claims department, staffed by competent and professional claims personnel, is vital to ensure the proper management of an insurance company's funds

- deal efficiently and fairly with all claims presented;
- identify quickly those claims which are not valid and advise the insured and their representatives quickly;
- assess and calculate the funds to be set aside to pay the claim for both indemnity and any attendant costs (e.g. for experts). These funds are known as reserves;
- instruct any necessary experts;
- settle claims cost-effectively; and
- liaise with colleagues in other areas of the insurer's operation to provide them with data relating to claims, both individual and in terms of trends and patterns.

Activity

Write some notes down about the things that might be important to you if you owned a ship and it sank, leading you to make a claim on your insurance policy.

What are your expectations of your insurer in terms of their claims handling service?

More detail about the claims process itself can be found in chapters 5 and 8.

Key points

The main ideas covered by this chapter can be summarised as follows:

Concept of risk and risk transfer

- Some risks are insurable and some are not.
- Insurable interest is always required together with a fortuity.
- Risk can be avoided, mitigated or transferred. Insurance is risk transfer but insurers still expect risk management to be done by the insured to mitigate risks.

Risk management

- Risk can be avoided, minimised, managed or transferred.
- Risk management is identification analysis and control of risk.

Components of risk

- Uncertainty, level of risk, peril and hazard.

Categories of risk

- Risks can be categorised as pure and speculative; fundamental or particular; and financial or non-financial.

Types of risk that can be insured

- Those which are of a financial nature, pure rather than speculative and particular rather than fundamental.
- A fortuity will be required, together with insurable interest.
- The risk must not be against public policy.
- One-off risks are not generally insurable although Lloyd's underwriters have a reputation for considering one-off risks.

Pooling of risk

- All insureds contribute to the pool by paying in a fair premium for the risk that they bring to the pool and they can make claims on the pool should they suffer losses.
- Insurers use the law of large numbers to assist them in working out the fair contribution together with historic knowledge.

Peril and hazard

- Peril is the thing that is being insured against, for example, fire.
- Hazard is something about the risk that might make the operation of the peril worse, for example, a thatched roof on a property, no sprinklers in a factory or a bad attitude to safety on a ship. Hazard can be described as physical or moral and both will be considered by insurers.

Reasons for buying insurance

- Depends on the attitude of an individual or business to potential risk.

Primary and secondary functions of insurance

- Transferring the risk.
- Resolves the need for large 'safety nets' of money for dealing with losses.
- Allowing the business to expand.
- Safety of jobs.
- Investment opportunities for insurers.
- Invisible exports from UK thus benefiting UK PLC.

Compulsory insurance

- Certain insurances are compulsory such as motor and employers' liability.

Insurance as a service industry

- Insurance is a service industry and customers will usually remember the claims service.

Question answers

1.1 The correct answer is b.

1.2 The correct answer is c.

1.3 The correct answer is b.

1.4 The correct answer is b.

1.5 The correct answer is c.

1.6 The correct answer is a.

1.7 The correct answer is c.

Self-test questions

1.	What is meant by insurance being a risk transfer mechanism?
2.	What are the main purposes of risk management?
3.	Give an example of a type of loss that would be described as high frequency, low severity; and then one which is low frequency and high severity.
4.	Give an example of a non-financial risk – why is it not insurable?
5.	Explain the difference between peril and hazard. Give examples of the two types of hazard.
6.	What is a speculative risk and how does it differ from a pure risk?
7.	Explain what is meant by fortuity.
8.	Why do insurers pool risks?
9.	Identify three primary reasons for purchasing insurance.
10.	Which insurance is compulsory for individuals in the UK?

You will find the answers at the back of the book

2

Basic insurance legal principles and terminology

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Learning objectives

After studying this chapter, you should be able to:

- outline the basic law of contract;
- explain the principle of good faith;
- define the meaning of proximate cause;
- define indemnity; and
- explain contribution and subrogation.

Introduction

In the previous chapter, we reviewed some fundamental principles of insurance such as risk.

In this chapter, we are going to review the basics of the law that applies to insurance contracts. It is important to understand that insurance contracts share many of the same fundamental ingredients as any other type of contract but with a few added elements which are specific to insurance.

Key terms

This chapter features explanations of the following terms:

Agreed value policies	Average	Average condition	Cancellation of insurance contracts
Common law	Common subject matter	Concealment	Conditional acceptance
Consensus ad idem	Consideration	Contract law	Contribution
Deductible	Duty of fair presentation	Estoppel	Excepted or excluded perils
Excess	Financial value	First loss policies	Franchise
Fulfilment of a contract	Good faith	Inception	Indemnity
Inner limits or item limits	Insurable interest	Insured perils	Legal relationship
Market agreements	Market Reform Contract (slip)	Misrepresentation	Modification by policy wordings
New for old cover	Non-contribution clause	Non-disclosure	Offer and acceptance
Postal acceptance	Proximate cause	Rateable proportion	Renewal
Salvage	Simple contracts	Spent convictions	Subject-matter of insurance
Subject-matter of the contract	Subrogation	Subrogation waiver	Sum insured
Tort	Unconditional acceptance	Underinsurance	Uninsured or unnamed perils
Valid contract	Voidable contracts		

A Contract law

The English law of contract is essentially a law of deals or agreements

The English law of contract is essentially a law of deals or agreements. It involves the relationship between two parties, one of whom agrees to perform or do something if and when the other party also performs or does something. A contract may be defined as 'an agreement, enforceable by law, between two or more persons to do, or abstain from doing, some act or acts, their intention being to create legal relations and not merely to exchange mutual promises.' (*English Law, Smith and Keenan*)

Applying this definition to insurance, it may be said that an insurance contract is: an agreement, enforceable by law, between an insured and an insurer.

The insured agrees to pay a premium to the insurer and abide by the terms and conditions of the policy. In return, the insurer agrees to pay to the insured a sum of money or provide something of monetary value, on the happening of a specified event, e.g. the submission of a claim.

Main purpose of insurance

As we saw in chapter 1, the main purpose of an insurance contract is to pay claims to policyholders should they suffer loss or damage covered by the terms of the insurance.

The idea effectively restores the insured to the position that they were in before the loss, e.g. repair the building that has been damaged by fire to the state it was in before the fire occurred.

This is called 'indemnifying the insured' and will be discussed further in section G.

How do both parties enter into this legally binding agreement and what conditions must be satisfied by both parties to ensure that the contract is a valid one? What will the results be if the ingredients are not all there?

First, let us look at the essentials of a valid contract and then at the way in which an insurance contract differs from other commercial contracts.

A1 Essentials of a valid contract

To ensure that a valid and enforceable contract is formed, an agreement must satisfy certain criteria. Two of the most important are:

- offer and acceptance; and
- consideration.

There are other important elements of a valid contract which are listed below:

Contract element	Explanation
Intention to create a legal agreement	The parties are acting deliberately.
Possibility of performance	Can what is being agreed in the contract actually be done? A contract to fly to the moon on a hang glider would be impossible to perform.
Capacity to enter into legal relations	Capacity is a legal concept and deals with the legal ability to make decisions. With one or two exceptions, young people under the age of majority (18) are not deemed capable of entering into contracts, and nor are those with diminished mental abilities.
Consensus ad idem (literally: meeting of minds)	Do both parties believe they are agreeing to the same thing – see the 'Consider this' box below.
Legality	Is the contract legal? An example of an illegal contract would be one to commit a criminal offence.
Certainty	Are the terms of the contract clear and unambiguous and are all parties entirely clear as to their obligations?

Consider this…

If you went to a railway station and asked for a ticket to Ashford, meaning Ashford in Kent, and the cashier sold you a ticket for Ashford, Middlesex, do you think there has been a meeting of minds – literally did both parties think they were agreeing to the same thing?

Question 2.1

A property insurer looks at a slip and sees that the risk location is Newcastle. He does not ask any questions but believes that this is Newcastle upon Tyne. The risk is in fact in Newcastle under Lyme. What key aspect of a contract is missing in this example?

a. Offer ☐

b. Acceptance ☐

c. Meeting of minds ☐

d. Consideration ☐

A contract may be declared invalid or set aside if it is missing any of these essentials. It cannot exist in law even though the parties involved may want it to. The legal term for this is that it is ***void ab initio*** (from the beginning). Various consequences may result from this which are out of scope of this syllabus.

A contract may be declared invalid or set aside if it is missing any of these essentials

Reinforce

Think of a contract as a cake which has a specific recipe that must be followed. If you miss out one of the ingredients, then however much you might want to make a cake, you will have a soggy mess or a dry pile!

All parties to a contract must act in good faith which means that they must not mislead one another. Note how this provision relates to both parties which means that both the insured and the insurer have this obligation – we will come back to what this actually means later in the chapter.

All parties to a contract must act in good faith which means that they must not mislead one another

Only in certain circumstances is a document necessary and a simple contract does not need to be evidenced in writing. Insurance policies are simple contracts. It follows that a policy does not have to have been issued for cover to exist.

Although a policy is not required, it is good practice for all parties to have some evidence of the agreement. In the London Market this is embodied in the concept called Contract Certainty which requires all parties involved in the contract to know exactly what the terms are before inception and that some sort of evidence of the contract is issued to the insured a short time after inception. Evidence might be a copy of the Market Reform Contract (MRC) or a broker-created evidence of cover such as the Broker Insurance Document.

The MRC will be discussed in more detail in chapter 5F1 and in study text LM2.

Simple contracts

The term 'simple' in relation to an insurance contract is a legal one and refers to the legal status of the contract, not the ease of understanding the contents!

We will now discuss the basic legal principles of 'offer and acceptance' and 'consideration' as mentioned above.

A2 Offer and acceptance

A contract comes into existence when one party makes an offer which the other accepts unconditionally

A contract comes into existence when one party makes an offer which the other accepts unconditionally.

This statement seems straightforward enough and the following sections show how offer and acceptance work in practice.

A2A Unconditional acceptance

It is easier to see how unconditional acceptance works by looking at an example.

Let us consider the following conversation which is based on personal lines insurance where the use of proposal forms and direct contact (without a broker) is more usual.

Bill (from ABC Insurer): On the basis of your Proposal Form I can offer you cover, subject to driving being restricted to the named persons you have listed, for £350.

Tom: I accept.

In this example, Tom's acceptance does not alter any of the terms of Bill's offer. He has not tried to change any of the terms. The acceptance is said to be unconditional.

A contract is formed, subject to the other essential elements being present. To be effective, acceptance must be the final and unqualified agreement to the offer.

A2B Conditional acceptance

If new terms are introduced, the so-called acceptance becomes a new offer (a counter-offer) which is open to be accepted or rejected by the person who made the original offer. This is shown in the example below.

Now consider an alternative response by Tom.

Bill (from ABC Insurer): On the basis of your Proposal Form I can offer you cover, subject to driving being restricted to the named persons you have listed, for £350.

Tom: I accept, so long as I can have 'any driver' cover.

In this scenario, a contract has not been formed as Tom has not unconditionally accepted the offer.

Not until Bill accepts Tom's counter-offer, without further conditions, is a contract formed. A counter-offer operates as a rejection of the original offer: ***Hyde v. Wrench* (1840)**.

Reinforce

Think about a simple activity such as going shopping for some clothes. You want a certain item and you ask the shop assistant for it, but the shop assistant suggests an alternative piece of clothing instead. This is like a game of table tennis with the offer and acceptance being bounced between both parties.

A2C Postal acceptance

The general rule is that the contract is made when the acceptance is received by the offeror (the person making the offer). However, where the parties have agreed to use the post as the method of communication, acceptance is complete at the point when the letter of acceptance is posted.

This rule applies even if the letter is delayed, or is lost or destroyed in the post and never reaches the offeror: ***Household Fire Insurance Co. v. Grant* (1879)**. In this case, Grant applied for shares in the Household Fire Insurance Company. The insurance company properly posted the letter accepting his offer, but it never arrived. The court decided that the offer had been accepted when the acceptance was posted, so there was a valid contract.

With the development of electronic communication methods, the law has had to extend to cover these situations; however, a further discussion of this area of the law is outside the scope of this syllabus but will be covered in more detail if you study unit M05.

A2D Offer and acceptance in practice

Let us now bring together everything we have learnt so far about offer and acceptance and see how it works in an insurance situation – see Example 2.1.

Example 2.1

Kevin buys a new car and knows that he needs to have insurance in place before he can pick up the car from the showroom. Kevin gives details of the risk to be insured to Flashcar Insurance and it responds by quoting him a premium of £500 together with some requirements such as having an alarm. This is an offer from the insurers to Kevin.

He accepts the premium and terms by notifying the insurer and the insurer is then 'on risk' (another use of the term 'risk', which in this context means that there is now a contract with Kevin and any losses covered by the policy, which occur from that point onwards, will be met).

B Consideration

We shall now consider the essential element of consideration, which is necessary to ensure that a valid contract is formed.

Contracts must be supported by consideration to be valid. But what exactly is consideration? It was legally defined in ***Currie v. Misa* (1875)** as 'some right, interest, profit or benefit accruing to one party, or some forbearance, detriment, loss or responsibility given, suffered or undertaken by the other.'

Contracts must be supported by consideration to be valid

Consideration may be described, simply, as each person's side of the bargain which supports the contract. The consideration from the insured is generally the payment of the premium and the consideration from the insurers is the promise to pay valid claims. Consideration does not have to be in money form and often commercial contracts are made on the basis of a consideration that may be expressed in shares, or even a truly nominal amount of money such as 1p.

Reinforce

Remember that the main reason for buying insurance is the insurers' promise to pay valid claims.

C Insurable interest

In this section, we shall examine insurable interest and its place in insurance. It is not one of the ingredients of a basic contract but is the first of the additional elements of an insurance contract.

C1 Definition of insurable interest

Insurable interest is one of the elements necessary to create a valid insurance contract and may be simply defined as 'the legal right to insure arising out of a financial relationship recognised at law, between the insured and the subject-matter of insurance.'

C2 Features of insurable interest

The following features of insurable interest may help to clarify the definition:	• subject-matter • need for a legal relationship, but not necessarily ownership • financial value
It is important to consider some related terms to clarify other aspects of insurable interest:	• insurer's own insurable interest • timing of the insurable interest (particularly anticipated insurance interest)

We'll now examine each of these features and terms in turn.

C2A Subject-matter

It is important to look at both subject-matter of insurance and the subject-matter of the contract

Within the concept of subject-matter, it is important to look at both subject-matter of insurance and the subject-matter of the contract.

Subject-matter of insurance	This is what is actually being insured, be it a physical thing such as a building, a car, a ship or some livestock, or the potential to be held legally liable for loss or damage to someone else or their property.
Subject-matter of the contract	This is the relationship that the insured has with the subject-matter of insurance. It might be ownership of property, responsibility for the safe-keeping of goods stored in a warehouse, or liability as the owner of a restaurant if the customers contract food poisoning.

C2B Legal relationship

The relationship of the insured with the subject-matter must be recognised in law for insurable interest to exist

The relationship of the insured with the subject-matter must be recognised in law for insurable interest to exist. Merely feeling responsible for something is not adequate; however, it is important for insurers handling international business to appreciate that the legal position differs from country to country and what is recognised under English law may not be under another country's law, and vice versa.

C2C Financial value

The idea here is that should something bad happen then the insured may have a financial downside, either because something has been damaged or destroyed, or because they have incurred a legal liability which may result in an award of damages against them.

Activity

Think about yourself or a member of your family and note down here what insurable interests they might have through owning or being responsible for something.

Then think about the company you work for – use common sense at this point and think about the things they own or are responsible for – note down your answers below and then go and speak to a senior colleague and see what they think.

Question 2.2

Maria runs a warehouse where she accepts customers' goods for storage. Her contract with the customers makes clear that she is responsible for keeping them safe whilst in her care. Which insurance principle allows her to buy insurance against her liabilities?

a. Offer ☐
b. Acceptance ☐
c. Consideration ☐
d. Insurable interest ☐

C2D Insurer's own insurable interest

Insurers themselves have an insurable interest allowing them to purchase reinsurance to protect them from the risks they have written. Reinsurance is considered further in chapter 3.

C2E Timing of insurable interest

Timing of insurable interest: a summary

Life assurance contracts. Insurable interest must exist at inception but need not exist at the time of a loss.

Marine insurance contracts. Insurable interest must exist at the time of a loss but need not exist at inception although a reasonable expectation of acquiring one is required.

General insurance contracts. A general rule that insurable interest must exist both at inception and at loss; however, an anticipated interest may be sufficient at inception.

C3 Creation of insurable interest

In this section, we will briefly review the different ways in which insurable interest can arise or be created.

Common law

We all owe duties to each other and have certain rights under common law. These give rise to insurable interests. The most obvious examples of this are ownership or exposure to liabilities to others under the law of negligence.

For example, a local council is responsible for ensuring that pavements are well-maintained. This responsibility is often called having a duty of care. If they breach that duty of care, or in other words fail to keep the pavements safe, someone might fall and hurt themselves. The council runs the risk of being found to be negligent by not looking after the pavement properly and will have to pay the injured person damages for the injuries. Liability insurance covers those damages if the insured is found to be negligent in law (not if they just feel a bit guilty!).

Contract

There are situations (when we enter into a contract) in which we accept greater responsibilities and therefore liabilities than those imposed by common law. For example, a landlord is liable under contract to their tenant to maintain the property; however, they can enforce responsibilities onto the tenant under the same contract.

Statute

There are some statutes which **impose a positive duty,** thus creating an insurable interest. Examples of these statutes imposing duties are:

There are some statutes which impose a positive duty, thus creating an insurable interest

- **Settled Land Act 1925**; and
- **Repair of Benefice Buildings Measure Act 1972**.

These statutes make the tenants responsible for the upkeep of the buildings they occupy. This gives the tenants an insurable interest in the building.

Statutes modifying insurable interest

There are also statutes which **restrict liability** and, therefore, restrict the financial value element of insurable interest. For example:

There are also statutes which restrict liability and therefore restrict the financial value element of insurable interest

- The **Carriage of Goods by Sea Act 1971** limits the liability of a carrier to a specific amount.
- **Hotel Proprietors' Act 1956** – liability only exists if a room has been booked and damage occurred during the time the guest was entitled to use the accommodation.
- **Carriers' Act 1830** – no liability for goods such as gold, silver, watches, clocks, jewellery, china, pictures worth more than £10 unless value declared when goods put into the care of the carrier.

Activity

Consider the following scenario and list all the different parties that might have an insurable interest, with reasons why.

A shopping mall is owned by a property development company and has 30 different shopping outlets and a small cinema. The shopping outlets are rented to a number of different companies but the owners run the cinema themselves.

There is a food court within the complex, together with a supermarket, pharmacist and a dry cleaner.

Cleaning is done by an independent company which is responsible for washing floors, cleaning toilets and ensuring that litter is collected.

D Duties relating to the information shared by the insurer and insured during contract negotiation

D1 Good faith

When talking about contracts in general terms earlier in this chapter we looked at the nature of all contracts. All parties to a contract must act with good faith and this is also true with insurance contracts.

Many contracts involve the purchase of a tangible product such as a piece of furniture or a car. A purchaser can inspect a tangible item at the time they buy to check that it is of good value. Provided that the seller does not mislead them (for example, by showing a sample that is unrepresentative of the actual product), the law expects buyers to satisfy themselves about the obvious properties of the product they are buying.

There are some obvious difficulties when trying to apply this principle to insurance contracts.

Consider this...
Although the potential customer can inspect a specimen wording for a policy before proceeding with the purchase, this is clearly not the same as being able to inspect a table before buying it and in reality will rarely happen.

A policy is only really 'tested' in terms of adequacy and quality when a claim is made – and neither the insured nor the insurer wants this to happen. Thus, from the point of view of the proposer the insurance product is intangible – it is a promise as yet untested.

If we look at insurance from the insurer's viewpoint, we can also see that the insurer is reliant upon a proposer for most of the important details about the risk that is being offered. At the start of their relationship, the insurer knows nothing about the prospective insured and the risk being presented for consideration.

D1A Principle of good faith in pre-contract negotiations

The principle applies equally to both the proposer and the insurer throughout the contract negotiations and essentially means that both parties should be open and transparent with each other in the sharing of key information relating to the risk.

However, it applies rather differently to each party. It is the proposer who has the duty to disclose all material facts about the risk to the insurer. The nature of the subject-matter of the insurance contract and the circumstances surrounding it are facts known mainly by the **insured**.

The insurer, on the other hand, must be entirely open with the proposer in other ways, for example, they cannot:

- introduce new non-standard terms into the contract that were not discussed during negotiations; or
- withhold the fact that discounts are available for certain measures that improve a risk.

Consider this...
An example of a measure that would improve the risk is the fitting of a sprinkler system for a fire policy on a commercial building.

On the face of it, the duty is a difficult one for the insured in particular to bear as, whether or not they are asked, they have to:

- disclose all facts; and
- know what is material.

Two key concepts that will be discussed in this section are disclosures/non-disclosures – when something is said, or not, and representations/misrepresentations – when something is said but it is not always accurate/true.

D1B Legal position if the insured is a consumer

A consumer is defined as someone who is buying insurance wholly or mainly for purposes unrelated to their business, trade or profession.

The consumer, under the **Consumer Insurance (Disclosure and Representations) Act 2012**, has a duty to take reasonable care not to make a misrepresentation to their insurers, and whether they have exercised reasonable care will be considered in light of all the relevant circumstances.

There are two types of misrepresentations under this Act which are:

- careless;
- deliberate or reckless.

The insurer will have to show that without the representation they would not have entered into the contract or would have done so on different terms. Additionally, the burden is on the insurer to argue that a representation was not just careless, it was deliberate or reckless.

A misrepresentation is deliberate or reckless if the consumer:

- knew that it was untrue or misleading, or did not care whether or not it was untrue or misleading; and
- knew that the matter to which the representation related was relevant to the insurer, or did not care whether or not it was relevant to the insurer.

If the insurer can prove deliberate or reckless, their remedies are avoidance of the contract and refusing all claims, and in addition, need not return any premium unless it would be unfair to the consumer to retain them.

If the representation is merely careless, then the insurer's remedies depend on what they would have done without the representation.

If there are claims involved:

- If they would not have entered into the contract on any terms, then they may avoid the contract and return the premium.
- If they would have entered the contract but on different terms (not including those relating to premium), then the contract is to be treated as if it had been entered into on those terms if the insurer so requires.
- If the insurer would have entered into the contract but would have charged a higher premium, then the insurer may reduce proportionately any amounts to be paid on a claim.

If there are no claims involved:

- The first two bullets above apply as before.
- An insurer can give notice to the consumer either of the termination of the contract or the variation of the contractual terms.
- Insured can also give notice to terminate.
- Premiums must be repaid for the balance of the contractual term.
- Any claims arising during a notice period before termination will have to be considered in the usual way.

Innocent misrepresentation does not give the insurer the right to decline a claim payment for personal insurances.

The Claims Handling section of the Insurance Conduct of Business Requirements (ICOBS) contains the main rules and guidance. The over-arching requirement is that insurers must not unreasonably reject a claim. ICOBS currently includes a definition of what would be considered 'unreasonable' grounds for rejecting a claim (unless there is evidence of fraud) from 'consumers', as follows:

The over-arching requirement is that insurers must not unreasonably reject a claim

- non-disclosure of a fact material to the risk which the policyholder could not reasonably be expected to have disclosed; and
- non-negligent misrepresentation of a fact material to the risk.

D1C Legal position if the insured is not a consumer

The **Insurance Act 2015** contains the law on disclosure and representations for non-consumer insureds.

Under section 3 of the Insurance Act, the insured must make a fair presentation of the risk to the insurer. Fair presentation is defined as:

> one which makes disclosure of every material circumstance which the insured knows or ought to know, or disclosure which gives insurers sufficient information to put a prudent insurer on notice that it needs to make further enquiries.

The definition goes on to say that the disclosure should be on matters which are reasonably clear and accessible to a prudent insurer and that material representations as to fact should be substantially correct, while those relating to a matter of expectation or belief should be made in good faith.

Case example

The leading case that explained the duty of disclosure in insurance contracts was ***Carter v. Boehm*** **(1766)**.

In this case, Mr Carter had taken out an insurance policy against the fort he was governor of (in Sumatra) being taken by a foreign enemy whilst being aware that the fort was not built to withstand attacks from European powers. When it was taken Mr Boehm refused to pay out on the insurance.

In this case, Lord Mansfield said:

Insurance is a contract upon speculation. The special facts, upon which the contingent chance is to be computed, lie most commonly in the knowledge of the insured only: the underwriter trusts to his representation, and proceeds upon the confidence that he does not keep back any circumstance in his knowledge, to mislead the underwriter into a belief that the circumstance does not exist, and to induce him to estimate the risk as it did not exist.

D2 Materiality

The concept of materiality is one which is not new and exists in the pre-existing law on disclosure and representations, which is contained in the **Marine Insurance Act 1906** and states that 'Every circumstance is material which would influence the judgment of a prudent insurer in fixing the premium or determining whether he will take the risk'.

Prudent insurer

This definition says a 'prudent insurer', not the actual insurer – this is a very important point in relation to the legal tests for materiality of any particular piece of information.

What is a material fact?
Examples of the types of information that insurers consider to be material include:

- **Physical hazard**. For example, information about the construction of a building and the type of heating system installed.
- **Moral hazard**. For example, whether the proposer has any criminal convictions, any insurance declined previously or any fraudulent claims discovered.

However, the key changes within the Insurance Act are:

- the insured cannot data dump on the insurer – the presentation must be reasonably clear and accessible; and
- the insurer has to consider whether the presentation invites further questions to be asked; the burden to ensure these questions are asked, if needed, is on the insurer – this complies with the insured's duty to place a prudent insurer on notice that they need to make further enquiries. This is very important as, although the responsibility is equally balanced between the insured and the insurers, the latter have a responsibility to review and ask questions as they will have no redress if this is left until a later date.

The Act sets out the scope of the insured's actual or imputed knowledge

The Act sets out the scope of the insured's actual or imputed knowledge – this includes in an organisation, matters known by senior management and those responsible for the organisation's insurances including the brokers, although this does not include any confidential information which might be held by the broker, for example, which the broker did not obtain from their client.

The Act also discusses in section 4 what the insured 'ought to know' and the definition of this relates to the conduct of a 'reasonable search of information available to the insured'. The key here is that the larger the organisation, the more widespread the internal request for information will have to be. The word 'reasonable' is very subjective, so this element is likely to be a topic of litigation at some point in the future!

The final point to note about assumed knowledge on the part of the insured is contained in section 6; here, it says that information the insured suspects but deliberately refrains from confirming will be included as what the insured 'knows', hence, no opportunity remains to turn a blind eye to matters.

There are a number of matters that do not have to be disclosed to insurers

There are a number of matters that do not have to be disclosed to insurers. Section 3 of the Act states that in the absence of enquiry, the insured does not need to disclose circumstances if:

- it lessens the risk;
- the insurer knows it;
- the insurer ought to know it;
- the insurer is presumed to know it; or
- it is something as to which the insurer waives information.

Examples of facts that do not need to be disclosed

This is either because the insurer ought to know them or could find them out.

Facts of law	Everyone is deemed to know the law. It follows that those actions that the proposer needs to take in order to comply with the law do not need to be declared specifically, even if material.
Facts of public knowledge	These would include items such as the fact that a state of war exists, or that a particular area or country is subject to natural catastrophes, subsidence, hurricane or flood. It would also include such things as industrial processes that are standard for the trade.
Facts that lessen the risk	It would be unusual not to advise the insurer of facts that lessen the risk. This is because they are matters that usually have the effect of producing a lower premium or better cover. Nevertheless, there is no requirement to disclose them. The fitting of an intruder alarm is an example of an improvement to a theft risk that the insured/proposer is not bound to disclose.
Facts where the insurer has waived its right to the information	Such facts would include those where the proposer has not answered a question on a proposal form, or has just inserted a dash. If the insurer does not follow this up, it is considered to have waived its right to that information. The insurer cannot claim non-disclosure in the future. The only exception might be where the non-answering of any question could be construed as answering the question in the negative. Each question on a proposal form should be present for a reason, in that it relates to information in which the insurer is interested. It is therefore important that insurers check carefully at an early stage whether any further information is required to enable them to make their decision.
Facts that a survey should have revealed	This only applies in circumstances where an insurer has actually carried out a survey. Provided that the proposer has not concealed anything from the surveyor, if the surveyor misses something of importance that is a material fact, the insurer cannot subsequently claim non-disclosure by the insured. This is because the insured has no way of knowing what the surveyor may or may not have noted during a survey.
Facts that the insured does not know	This category needs an explanation because different rules apply to people acting in their private capacity as compared with commercial insurances. Broadly speaking the tests are: • whether the requirement for disclosure was reasonable; and/or • whether the fact was material. Specific examples include: • **Facts covered by policy terms**. The insured is not required to declare those things that are specifically dealt with by policy terms. For example, the fact a person enjoys underwater pastimes is not relevant when applying for a personal accident insurance, if the policy excludes such activities. Obviously, if the policy does cover underwater activities, then the matter becomes material. • **Spent convictions**. Under the terms of the **Rehabilitation of Offenders Act 1974** (as amended by the **Legal Aid, Sentencing and Punishment of Offenders Act 2012** (LAPSO))*, certain offences are treated as if they had never been committed after differing periods of time. The timing varies according to the severity of the sentence imposed. With effect from 10 March 2014 in England and Wales, for example, the rehabilitation period for a fine is one year. A custodial sentence of four years or more is never 'spent'. For offenders under 18 years of age, the rehabilitation periods are halved.

*Although there are some exceptions, the practical effect for insurers is that it is perfectly in order for a proposer to state that they have had no convictions provided that they are 'spent' under the terms of the legislation. It follows that insurers that have imposed restrictive policy terms under a motor policy solely because a driver has been convicted of a motoring offence, must remove those restrictive policy terms once the conviction becomes 'spent'.

Activity

Review **Annex A** of the ABI's **Good Practice Guide to Insurers' Approach to People with Convictions and Related Offences** for the full list of rehabilitation periods now applicable in England and Wales. Available at: www.abi.org.uk.

Section 5 of the Insurance Act specifically deals with the knowledge of the insurer and defines that the insurer knows something if it is known by one or more of the individuals who participate on behalf of the insurer in the decision to take the risk (i.e. usually the underwriters). However, the Act specifically also includes those who might accept the risk outside the insurer's organisation such as someone acting under a delegated underwriting agreement.

When it comes to the '**ought to know**' or '**presumed to know**' categories, the Act also defines these concepts:

- The insurer **ought to know** something if it is known by an employee or agent of the insurer and the information ought reasonably to have been passed on to the person making the decision to accept the risk, or if the information is held somewhere within the organisation and is readily available to the person making the decision.
- The insurer is **presumed to know** things which are common knowledge and things which an insurer operating in this class of business would reasonably be expected to know.

Just as we saw with the insured, the insurer cannot turn a blind eye to information that they suspect but choose not to follow up on.

Activity

Think about which other areas of the insurer's organisation might know relevant information which should be shared with the underwriters, do you think the claims team is an obvious area?

How best do you think information should be shared within the business?

D3 Role of the broker

The insured's knowledge includes the knowledge held by one or more of the individuals responsible for the insured's insurance which can, therefore, include brokers, but there is no longer a separate expressed duty of disclosure on the part of the broker as there was previously.

D4 Remedies

Under the Insurance Act, there are a number of remedies for breach of the duty of fair presentation. The first decision to be made is whether the breach was deliberate or reckless, or neither deliberate nor reckless. The second decision is whether the breach took place as part of the original risk placement or in relation to any variation of the contract.

Original placement

If the breach was deliberate or reckless – which is defined as the insured knew that they were in breach and did not care – the insurer can avoid the policy from the start (*ab initio*) and they can retain the premium.

However, if the breach was neither deliberate nor reckless, the insurer's remedy depends on what their response would have been to the correct information, had it been presented:

- If the insurer would not have entered into the contract at all if the correct information had been presented, then the insurer can avoid the contract but they must return the premium.
- If the insurer would have entered into the contract on different terms (not including the premium) then the contract will be treated as if those terms were included.
- If the insurer would have charged a higher premium, then the remedy is not that an additional premium can be charged, but that any claim will be reduced on a proportionate basis. Therefore, if the insurer feels that they have in fact only received 80% of the premium they were expecting, only 80% of the value of any otherwise valid claim will be paid.

Variation

A variation or change to an insurance contract can occur at any point after the original placement is concluded. A variation can be anything from a simple change, such as the correction of a spelling mistake, or something more substantial, such as adding a new asset to an insurance policy. Whatever the nature of the change the new law applies specific remedies depending on the nature of any breach of the duty of fair presentation:

- If the breach is deliberate or reckless, insurers can terminate the contract from the time of the breach and do not have to return the premium.
- If the breach is neither deliberate nor reckless and the premium stayed the same or increased due to the variation, and
  - if the insurer would not have agreed to the change they can treat the contract as if the change never took place, but they have to return any additional premium charged; or
  - if the insurer would have agreed to the variation but on different terms (including premium) the contract will be treated as if the changes have taken place and if more premium should have been charged the claims will be impacted as explained above.
- If the breach is neither deliberate nor reckless but the premium was reduced because of the change, and
  - if the insurer would not have agreed to the change, then they can treat the contract as if the change had never happened, but any claims will be penalised as the insurer has now received less premium than they originally wanted; or
  - if the insurer would have agreed to the change but on different terms these different terms will be applied.

D5 Contracting out

It is possible for the parties to the insurance contract to agree that the provisions of the Insurance Act 2015 will not apply and, therefore, that the previous law on disclosures will apply. However, the Insurance Act places a burden on the insurer to be very transparent in their explanation to the insured of the impact of doing this. If the insurer does not do this, any apparent contracting out within the documentation may have no legal effect. The Act anticipates different requirements based on the relative customer sophistication and also recognises that if a broker is involved the broker also has a duty to their client to alert them to the potential disadvantages of this choice.

D6 Compulsory insurances

As we saw in chapter 1, there are certain insurances which are required by statute – a fact which impacts on an insurer's rights following a breach of the duty of disclosure. The most common example is motor insurance (third party personal injury and third party property damage). The **Road Traffic Act 1988** prohibits the insurer from avoiding liability on the grounds of certain breaches of good faith.

Exactly the same rules of disclosure apply to motor insurance contracts as to other non-life classes of insurance. However, the law is primarily concerned that the innocent victims of road accidents should be adequately compensated, and this aim would be defeated if an insurer could avoid paying claims on the grounds of non-disclosure by the insured.

Insurers must, therefore, meet all claims for personal injury and property damage made compulsory under the legislation. Once they have done so, they then have a right of recovery against the insured. They will usually seek to recover what they can in such circumstances.

D7 Insurer's duty of disclosure

The insurer also has a duty of disclosure to the insured. In order to fulfil this duty, the insurer must also behave with good faith; for example, by explaining clearly the various products available and the options available to the insured and an insurer's ability to reduce premium if an insured fits sprinklers or superior locks to property.

The insurer also has a duty of disclosure to the insured

Activity

If you, or someone you know has car, house or contents insurance, have a look for the Key Facts document; the tool used by insurers to try to set out the details of the cover in clear terms to ensure that they remain compliant.

D8 Modification by policy wordings

For many types of insurance, instead of a duty of disclosure that only lasts until the risk is actually placed, the insurer requires a continuing duty to disclose material information. In such cases, there must be a specific policy condition that makes this clear.

Under common law, the duty of disclosure starts when negotiations begin and ends when the contract is formed (at inception)

At inception

Under common law, the duty of disclosure starts when negotiations begin and ends when the contract is formed (at inception). From that point until renewal negotiations take place, there is no requirement for the insured to declare material facts unless these affect the policy cover. For example, if the value of property increases or a car is sold and another purchased it is clear that the insurer must be advised because the policy requires a specific endorsement to accommodate the change in risk. However, a policyholder does not need to disclose a conviction for fraud (which would be a material fact for all general insurance policies) until the following renewal.

The exception would be if there was a specific policy condition which extended the duty of disclosure so that it became a continuing one.

On renewal

On the renewal of a policy, the insured's duty of disclosure is revived for general insurance (non-life) policies.

All general (i.e. non-life) insurance policies (such as fire, theft, liability and certain marine and aviation policies) are contracts that are renewable, usually after twelve months. When the contract ends it is customary to offer renewal terms. If accepted, a new contract is formed. The duty of disclosure is revived during the period of negotiation and applies as for new contracts.

It is important that you distinguish between the requirements for short-term policies and those for long-term policies (such as life and pensions policies).

Question 2.3

Why do insurers on long-term policies only require disclosure at the time of the original inception, whereas short-term policies require it at every renewal?

a. Nothing is expected to change in a long-term policy ☐

b. Each renewal is the creation of a new policy of insurance ☐

c. Long-term insurers trust their clients more ☐

d. General insurers do not trust their clients ☐

Once the requirements for disclosure have been met in the negotiations leading up to the inception of a long-term contract, the duty of disclosure ceases. Once the policy is in force, even if a material fact – such as the life assured's health – changes, it does not need to be declared. The only requirement for the policy to continue is that the insured pays the premiums when they fall due.

Continuing requirement

Insurers are often concerned that their rights at common law are limited because they do not need to be advised of certain material mid-term changes to a risk that they insure. They deal with this situation in different ways for different classes of insurance. Not all insurers adopt the same approach but the following table illustrates some of the issues.

Commercial property insurance	A policy condition requires continuing disclosure of removal of property to another location, or circumstances that increase the risk of damage to property.
Motor insurances	There is usually an onerous policy condition that requires continuing disclosure of all material changes by the insured, during the currency of the policy.
Public liability insurance	The continuing requirement for disclosure for this class of business arises from the fact that insurers tightly define 'the business' of the insured in the policy. This means that the insured must notify any extension of their activities for cover to apply. A condition requiring ongoing disclosure of material facts may be coupled with this.

Consider this…

Why might a public liability insurer want to know that a bowling alley that is being insured is now going to open a café serving meals to the customers? What sort of information will they want to know?

On alteration

During the term of a general (non-life) policy, it may be necessary to change the terms of the policy. The insured may wish to increase the sum insured, change the description of the property or add another driver to a motor policy. Where a change results in the need for an endorsement to the policy, the duty of disclosure is revived in relation to that change.

D9 Limitation of an insurer's right to information

In many cases it is the completion of a proposal form by the proposer that brings about insurance. The insurer constructs the proposal form with the intention that it will draw out all the relevant information relating to the risk. However, even if a specific question is not asked, the duty of disclosure means that the proposer must still disclose any information that is material.

If a question is asked, but the proposer only provides partial information in response and the insurer does not seek further details, then the insurer is deemed to have waived its rights regarding this information. The proposer is not considered to have failed to disclose a material fact in these circumstances. This applies to answers left blank on proposal forms or where a proposer has given a vague description of a business.

If an insurer clarifies what it means by a 'material fact' by defining exactly what is required in answer to a question on a proposal form, it is unable to claim at a later date that it required wider or further disclosure. In effect, it cannot claim that there has been a failure to disclose something material. This is the case in any situation where the insurer has requested what they regard as relevant information relating to a defined period.

Use of slips in the London Market

However, the London Market is slightly different in that most risks are not placed using a proposal form, but using a Market Reform Contract (still colloquially known as a 'slip') on which the risk details are summarised for the insurers' consideration. This document is drawn up by the insurance broker and does not include any questions from the insurers. This does not mean that the insurers cannot and should not ask any questions, just that they will do so following the presentation of the risk by the insurance broker and not through a pre-set list of questions which the proposer answers at the time of the first presentation of the risk.

The London Market is slightly different in that most risks are not placed using a proposal form

When there has been a breach of the duty of good faith/duty of fair presentation by the insured in relation to a non-consumer contract (subject to the exceptions noted above), the insurer will generally have the right to invoke one of the remedies in the Insurance Act which include avoidance, revision of the terms and so on. Timing will vary depending upon the circumstances. If an insurer chooses not to invoke their right to avoid the policy, it may simply waive its right and treat the policy as remaining in force.

However, insurers must exercise care because their conduct may prevent them from claiming that a breach of the duty of good faith/duty of fair presentation has occurred. For example, if an insurer knows that the insured deliberately failed to disclose a material fact in discussions leading up to inception of the policy, the insurer has the option to avoid the contract *ab initio*. However, the insurer must not act in a way that suggests that they have waived their right to avoid the contract. Such an action could be writing to the insured invoking a seven-day cancellation clause. It is clear that in doing this the insurer accepts that the policy is in force up to the date of cancellation.

The insurer has thus waived its rights and is **estopped** from avoiding the policy on grounds of non-disclosure at a later date. Consequently, should a claim occur between inception and the cancellation date, the insurer could not avoid payment of the claim on the grounds of non-disclosure.

Estoppel

Estoppel is the legal term used for a bar or impediment that precludes a person from asserting a fact or a right. It usually arises where one party's conduct has been relied upon by the other.

- This is a complex area but the practical application is as follows: insurer has to be very careful not to lead insured into a false sense of security concerning the policy validity.
- For example, insurers will want to carefully investigate an alleged non-disclosure or misrepresentation as it is a serious allegation to make against the insured. If they do not say anything about their concerns to either the broker or the insured then the insured will potentially be under the impression that everything is fine and then will get a nasty surprise when the insurers try and cancel the policy.
- At this point, the insured could claim estoppel – saying that they had relied on the silence from the insurers as evidence of everything being satisfactory and it was unfair to now cancel the policy.
- There is a chance that a court might agree with them, depending on the actual facts of the case, and insurers would end up not being able to cancel the policy.

The key is the insurer cannot unnecessarily delay any decision it makes to avoid or cancel the policy, as fundamentally that would be unfair to the insured.

E Cancellation of insurance contracts

Once an insurance contract has been concluded, it is expected to continue until the agreed expiry or renewal date. Some insurances are designed for short periods – for example, travel insurance. Others such as motor, fire or home insurance are renewable contracts that will continue, typically, for one year whereby the insurer usually offers terms for renewal at the end of that period. There is no obligation upon the insurer to offer renewal terms.

However, the FCA principle of fair treatment of customers, coupled with the requirement to provide customers with information so that they can make an informed decision regarding their insurance arrangements, implies that the insurer must alert the customer to the fact that cover will expire and that renewal is not being offered 'in good time', which is determined by the point in the renewal process at which the information may be most useful.

If an insurer is planning not to renew a client's policy, it must warn the client in enough time for the client to make other arrangements

Put even more simply, if an insurer is planning not to renew a client's policy, it must warn the client in enough time for the client to make other arrangements.

There are some situations in which either the insurer or the insured may wish to cancel cover during the currency of the policy. This is governed by the written terms and conditions in the policy.

E1 Insurer's rights

Most general insurance policies have a cancellation condition. This allows the insurer to cancel, provided that a letter is sent to the insured's last known address (usually by recorded delivery or registered post) giving 14 days' notice of cancellation. The period of notice is not standard, some insurers state 10 days', others 30 days'. If the insurer invokes this cancellation condition a *pro rata* return premium is sent to the insured, representing the unexpired portion of the risk.

This is not common practice at all, but it could happen. Examples would be if there has been difficulty with a claims settlement and the insurer feels that the insured has acted unreasonably and certainly if the insured has been guilty of fraud in connection with a claim.

Some policies that provide war coverage (particularly in the marine market) have cancellation provisions which operate in two ways:

- To allow cancellation on short notice but with immediate re-activation allowing the insurers to increase the premiums if the subject-matter insured is likely to enter high risk areas, such as the waters off Somalia.
- To allow immediate cancellation of the policy if war breaks out between any two of five named countries.

E2 Policyholder's rights

It is less common for the insured to have cancellation rights. Some insurers permit this in their wordings, even allowing a proportionate return of premium. However, it is much more common for the policyholder to have a right to cancel, but for the insurer to be entitled to charge for the cover already provided at their short-period rates. These rates represent a significant increase on the *pro rata* premium to reflect the fact that the insurer has spent sometimes significant amounts of money setting up a new policy. (Insurers must take care that these rates do not appear to be 'unfair'.)

It is less common for the insured to have cancellation rights

E3 Other means of terminating insurance contracts

As with any other contracts, termination may be as a result of the fulfilment of the contract or as a result of some problem in relation to the contract.

E3A Fulfilment

This means that the contract has been fully performed – it has done its job in other words. In an insurance sense, this will depend on matters such as the extent of financial coverage available under the policy. If the policy will pay out a maximum of US$50m any one policy year (irrespective of the number of individual claims) and has paid out that amount in the first six months of the policy period, then the contract has been fulfilled. In reality the policy will remain in force, but it will not be able to respond to any more claims.

E3B Voidable contracts

There are circumstances in which one party to a contract may set it aside. It is said to be voidable at their option. This may arise under insurance policies where the insured is in breach of a policy condition that places a continuing requirement upon them.

An example of this would be the deliberate failure to disclose material information – which gives the insurer the right to avoid the policy. It is a choice it must make, not an automatic cancellation.

However, you must distinguish this type of situation from one in which the insured fails to fulfil a condition relating to a claim. In this case, the insurer may have the right to avoid paying the particular claim, but the policy will remain in force.

Example 2.2

Some policies have provisions whereby the insured must advise the insurers of an incident that might give rise to a claim within a set period of time. Failure of an insured to comply with such provision could prejudice their ability to have their claim paid by an insurer, although the policy itself will still remain in force.

There may also be situations where the policy has never been in force. This would arise where there was no recognised insurable interest at the outset. In such cases, the policy is automatically void. This does not really amount to a termination since the contract has never been in force.

There may also be situations where the policy has never been in force

F Proximate cause

In this section, we shall look at the causes of loss and how these relate to the cover provided under a policy. We will then go on to apply the principles to straightforward claims situations.

When a loss occurs and the insured makes a claim for loss or damage, the insurer decides whether to meet the claim by asking the following questions:

- Is a valid policy in force?
- Is the cause of the loss covered under the policy?

Answers to both these questions can usually be found by checking the policy terms and conditions and the claims information. Sometimes, however, it is not clear what actually caused the loss or it might take some time to unravel the story.

In these circumstances insurers look at the loss, all the possible causes and the relationship between them, before deciding whether the claim is valid and then settling the claim.

F1 Meaning of proximate cause

Often the cause of a loss is straightforward and there is no need for a long investigation. A fire caused by an electrical fault is easy to establish. If a policy covers the peril of 'fire' the claim will be payable.

If two vessels are in a collision at sea, their respective policies will respond, to the extent that blame is apportioned according to the various policy wordings. There may need to be a lot of discussion about the apportioning of blame, but there is no doubt that the policies will respond because the cause is covered.

However, there are occasions when the cause of the loss is not so easily defined, either because there is a chain of events or there is more than a single cause. In such cases, we need rules to guide the way in which insurers should deal with such losses.

This is when insurers apply the doctrine of **proximate cause**.

Case example

An insurance policy covers a particular loss caused by an insured peril. Insurers look first at the relationship between the peril and the loss to establish the proximate cause of the loss. They must then decide whether or not the cause (peril) is insured, before paying the claim. Proximate cause was defined in the case of ***Pawsey v. Scottish Union and National* (1907)**.

In this case which arose out of an earthquake in Jamaica, Mr Pawsey suffered fire damage to his premises and made a claim on his policy. His policy, however, excluded earthquakes and the court supported the insurers position and found that the earthquake was the proximate cause of the loss as without the earthquake there would have been no fire.

Proximate cause means the active, efficient cause that sets in motion a train of events which brings about a result, without the intervention of any force started and working actively from a new and independent source.

The proximate cause of an occurrence is always the dominant cause

The proximate cause of an occurrence is always the dominant cause and there is a direct link between it and the resulting loss. A single event is not always the direct cause of a loss: a loss sometimes occurs following a train of events.

A good way to picture the relationship between cause and effect is to imagine a row of dominoes, all standing. Imagine the first domino is pushed over, knocking the second which in turn knocks over the third and so on until they have all fallen down. The push of the first domino sets in motion the train of events which brings about the fall of the last domino. If we take the fall of this last domino to represent a loss, then the push of the first domino is, therefore, the proximate cause of the loss.

Imagine, however, that one of the dominoes does not fall as a result of the first domino falling. Instead. it is pushed by an onlooker. In this case, the train of events stops and the intervention of a new force, independent from the original train of events, becomes the cause of the last domino falling. It is, therefore, the new proximate cause of the loss.

Example 2.3

A vessel suffers torpedo damage and limps into a safe harbour. A storm is developing and the harbour master wants her out of the harbour so she is forced to leave. She sinks in the storm.

In this case, the proximate cause of her loss is the damage caused by the torpedo as without a large hole in her hull, she would have survived the storm.

In this practical example the proximate cause was important as storm damage was insured; however, torpedo damage was not!

Many situations involve, to a greater or lesser extent, several causes. In the case of ***Leyland Shipping v. Norwich Union Fire Insurance Society* (1918)**, Lord Shaw stated that 'Causation is not a chain but a net' going on to describe the proximate cause as 'proximate in efficiency'. This is particularly important as we consider more complex claims where there may be more than one contributing cause, and the causes may be insured, uninsured or excepted perils. These claims are beyond the scope of this course.

Question 2.4

While Michael was out riding his horse, he fell off. He was badly injured and was on the ground for some time before he was rescued. During his convalescence, he contracted pneumonia from being on the ground for such a long time and eventually died.

What was the proximate cause of his death – pneumonia or the fall from the horse?

F2 Nature of perils

Once the insurer has established the proximate cause of the loss, it must check whether the peril is covered by the policy. Perils can be classified as follows:

Perils can be classified as 'insured', 'excepted' or 'excluded', or 'uninsured' or 'unnamed'

- **Insured perils**: those named in the policy as covered.
- **Excepted or excluded perils**: those named in the policy as specifically not covered.
- **Uninsured or unnamed perils**: those perils not mentioned at all in the policy.

Insurers decide whether or not a straightforward claim is valid by establishing into which of the above categories the peril that was the proximate cause of the loss, falls. It is only necessary to find the proximate cause of a loss where the events before the loss are not all insured perils.

If they are all insured, the loss is covered. However, it may be necessary to determine which peril caused a loss if different policy terms apply to different perils in the chain. If there were a number of perils that caused the damage and it is impossible to allocate the damage to different perils then the following rules apply:

- If one of the perils is excluded then nothing will be paid at all.
- If one of the perils is not mentioned at all (neither specifically covered nor excluded) then the whole claim will be paid.

G Indemnity

The whole point of insurance is to ensure that when the bad things happen, someone other than you pays for it!

When an insured peril causes a loss, the insured submits a claim to their insurer for the loss. The insurer checks the validity of the claim and then, if valid, accepts it, agreeing to meet its obligation under the terms of the insurance contract. The actual settlement or the amount payable by the insurer depends on a number of factors, including:

When an insured peril causes a loss, the insured submits a claim to their insurer for the loss

- the nature of the cover;
- the extent of the cover; and
- any conditions limiting the amount payable.

Most short-term (non-life insurance) contracts are contracts to indemnify the insured in the event of a loss.

G1 Definition of indemnity

Indemnity can be defined as 'financial compensation sufficient to place the insured in the same financial position after a loss as they enjoyed immediately before the loss occurred.'

Reinforce

If your building is damaged by fire, insurance will pay for repairs that return it to the condition it was in before the fire.

Case example

The importance of the principle of indemnity was emphasised by Brett, LJ, in the case of ***Castellain v. Preston* (1883)**:

In this case, a house was being sold and during the sale process it was damaged by fire. Insurers paid out to the sellers who were neither prepared to pay the insurance proceeds to the buyers or to reduce the contractual sale price.

The key aspect of this case was to put in place the concept that the insured cannot profit from his loss – he cannot receive more than he lost. Having received the full purchase price from the buyers, the insurers were entitled to their funds back as the insured was in no worse position than he had been before the fire occurred.

The very foundation, in my opinion, of every rule which has been applied to insurance law is this, namely that the contract of insurance contained in a marine or fire policy is a contract of indemnity and of indemnity only…and if ever a proposition is brought forward which is at variance with it, that is to say, which either will prevent the assured from obtaining a full indemnity, or which gives the assured more than full indemnity, that proposition must certainly be wrong.

The key here is that the principle of indemnity does not anticipate the insured making a profit from their loss but as we will see, not all insurances are contracts of indemnity.

?

Question 2.5

The concept of putting the insured in the position they were in before the loss can be expressed as:

a. Meeting of minds ☐
b. Consideration ☐
c. Indemnity ☐
d. Subrogation ☐

G2 Benefit policies

Some short-term policies are not policies of indemnity

We can see straight away that some short-term policies are not policies of indemnity. The policies in question are those that provide fixed benefits, mainly for accident and sickness. These are short-term policies because the insurer has the option of inviting renewal at the end of each period of insurance. However, there is no way that a price can be placed on the loss of a limb or of sight, so the principle of indemnity cannot apply.

Insurers do try to take account of an individual's circumstances and earnings when agreeing to insure weekly benefits for temporary disablement. They do so because they do not wish the policy benefits to act as an incentive for the insured to remain off work longer than necessary.

Apart from life, pensions, annuity and investment contracts, policies that fall into the category of **benefit policies** include:

Aviation loss of licence insurance is covered in section I4B

- personal accident; and
- loss of licence for air crew.

G3 Options available to insurers

Now we have established that not all contracts of insurance are policies of indemnity, we will consider the vast majority that do seek to provide exact financial compensation. For any type of property insurance (and this would include the 'own damage' section of motor policies), although the insured is entitled to receive indemnity (within the limits of the sum insured as stated in the policy), there are different ways of providing indemnity. We shall examine these in more detail.

There are a number of settlement options open to an insurer which will provide the insured with the necessary indemnity, which are:

Settlement options are cash, repair, reinstatements and replacement

- cash;
- repair;
- reinstatement; and
- replacement.

The options available apply only if they are stated in the policy. If they are not, the insured has a legal right to financial compensation. These options have their origins in insurers wanting to find the most economical way of providing indemnity. For example, in the past, though not so much nowadays, insurers would have arrangements with some major jewellers. Insurers would then be able to replace very expensive jewellery at a discount. They would often do this rather than pay out the 'insurance valuation' price – which they may have considered an inflated figure provided by a valuer.

Historically too, insurers would sometimes arrange for the repair of carpets that were damaged. With the advent of 'new for old' type covers this practice has diminished.

Although these options have, therefore, historical significance, there are some helpful aspects to them which mean that insurers have found it useful to retain these options. Indeed some applications are even on the increase. Effectively, the options have remained the same, but the practical applications have changed.

G3A Cash payment

For many years, most insurance claims have been settled by the payment of money by the insurer directly to the insured. This is still the case, particularly with commercial insurances.

However, for personal insurances (in particular, home insurance) there has been, since the 1990s, a growing trend for insurers to use the replacement option through nominated retail chain stores. This will be looked at in more detail in section G3C but it is worth noting here what happens if the item offered by the insurer is not wanted by the insured.

Many insurance companies now have close relationships with retailers, and the insurer's bulk-buying power often means they can get quite large discounts (often as much as 20%) when purchasing goods.

However, the Financial Ombudsman Service (FOS) has indicated that where policyholders do wish to have a replacement they should be allowed to choose where they purchase this and they are entitled to a cash settlement if they cannot find an acceptable alternative. In these circumstances, the insurer would not be entitled to reduce the cash settlement to take account of the discount it would have received if the policyholder had bought the replacement from one of the insurer's nominated suppliers.

The settlement of claims for certain types of insurance always involves the payment of money. These types include money insurance, fidelity guarantee, business interruption and liability policies.

Who receives the money?

In the case of liability insurance, payment is made to the injured party, not to the insured.

G3B Repair

Where it is possible, insurers may opt to repair any damage to an insured item. In this way, they can provide indemnity, perhaps at a lower cost than the insured might achieve, because of the negotiating power of a large organisation. The most common example is in motor insurance claims, so let's look at an example to see how this works in practice.

Where it is possible, insurers may opt to repair any damage to an insured item

Example 2.4

Gary's car is involved in a collision. He notifies his insurer which arranges for the damage to be repaired at a garage approved by the insurer. The insurer pays the garage directly, rather than paying money to Gary.

In this scenario, the 'approved' or 'recommended' repairer will provide the insurer with guarantees in relation to workmanship and hourly rates, as well as the provision of courtesy cars, in return for a flow of business from the insurer.

It is important to remember that in many commercial policies of insurance, the item is repaired. However, it is usual for the insured to pay the repair costs up front and get indemnified by their insurer rather than (as often happens in motor insurance) the insurer taking control of the repair through its own contacts.

G3C Replacement

The most common example of replacement as a means of providing indemnity is glass insurance. Speedy replacement means further losses are minimised, such as when shop front windows are smashed.

The most common example of replacement as a means of providing indemnity is glass insurance

As we have seen, replacement is also often used as a means of settling household property losses. On these occasions, the policyholder simply orders a replacement item from one of the household name retail stores and the item is paid for by the insurer.

Reinforce

The main benefit to insurers in offering replacement is that it can deter those who might make false claims – thereby defrauding insurers. For example, if a fraudulent claim is made for a damaged DVD player, the insured will hope to receive a cash settlement. If however, the insurer exercises a right to replace, then the fraudulent claimant has two DVD players and not the expected cash.

With the rise of internet auction sites (and therefore the ease with which goods can be sold for cash), the use of replacements may not necessarily deter a fraudulent insured today but it can still act as a partial assistance to insurers.

G3D Reinstatement

Reinstatement is the fourth way that an insurer can provide indemnity. Reinstatement means that the insurer agrees to restore a building (or piece of machinery) that has been damaged by an insured peril.

However, this is not a popular option with insurers. The reason for this is that, unless the policy specifies otherwise, they are bound to reinstate the property so that it is largely in the same condition it was before the loss. In any event, they are their own insurers of the risk during the period of reinstatement. Also, once they choose to reinstate, they lose the certainty that the sum insured will be the maximum they have to pay out. This is reasonable, since the insurer can hardly insist on reinstatement and then, once the sum insured is exhausted, stop work regardless of whether or not the building is completely restored by that point.

Difference between reinstatement and repair

The distinction between repair and reinstatement may not be immediately obvious.

Reinstatement would apply only to buildings (and occasionally machinery) and is concerned with bringing the property back to its pre-loss condition. To achieve this purpose the insurer effectively takes occupation of the premises (or what is left of them) to reinstate. The option to repair does not carry with it the 'occupation' aspect.

G4 Application of indemnity

Property and liability policies are contracts of indemnity because a value can be placed on the subject-matter insured. This principle also applies to pecuniary insurances, such as business interruption. Remember from earlier in this section that life and personal accident policies are not contracts of indemnity as the insured cannot be restored to the same financial position after a loss.

G4A Property insurance

In the case of partial damage, indemnity is the repair cost less an allowance for wear and tear

As a practical example of indemnity cover in respect of property insurance, imagine a fire which destroys part of a school. Calculating the value of the loss may be a problem since the equipment is completely destroyed. The measure of indemnity is the replacement cost less an amount for wear and tear. In the case of partial damage, indemnity is the repair cost less an allowance for wear and tear. This is very much a theoretical starting point. Most property policies incorporate some form of 'new for old' cover.

G4B Liability insurance

A liability policy provides indemnity to the insured in respect of their legal liability to pay damages and the claimant's costs. The policy does not define the financial value of the indemnity, as this is often left to the courts to decide. However, it does lay down the elements (such as the payment of defence costs) to be included in an indemnity settlement. There will always be a limit to how much the policy will pay in the event of a claim, and this will be stated in the policy.

G5 Measuring indemnity

In this section, we will see how insurers measure indemnity for different classes of insurance.

Our starting point must be the financial value of the subject-matter of the insurance, but how is this financial value calculated? In the absence of policy conditions modifying the position, in property insurance, the value of the subject-matter of the insurance is its value at the time and place of loss. However, as we shall see, it is usual for policy conditions to apply which alter this position. We start by looking at different categories and types of insurance and considering the standard cover provided by them, before examining possible extensions.

G5A Marine insurance

See section G6A for more information on valued/agreed value policies

In a valued policy (which is the same as an **agreed value** policy), the insurable value is agreed between the insured and the insurer. The insurable value of an unvalued policy must be calculated using the formula in the Marine Insurance Act 1906. Thus, in both kinds of policy, there is an identifiable insurable value, effective from the start of the period of insurance (policy inception), and which is unaffected by subsequent market price variation. It usually corresponds to the sum insured. See section G6A for more information on valued/agreed value policies.

G5B Property insurance

The measure of indemnity for property is its value at the date and place of loss

The measure of indemnity for property is its value at the date and place of loss. This is a very broad guideline and we must look at the different types of property insurance in order to understand how the principle operates in specific cases.

Buildings: basic cover

This basic cover is referred to in the market as an 'indemnity' settlement, to distinguish it from reinstatement (see below). Insurers calculate the indemnity for loss of, or damage to, buildings as the cost of repair or reconstruction at the time of loss. They make allowances for anything that cannot be exactly repaired as it was before the loss and where the replacement has had to be new. This is termed **betterment**. It is very unusual for buildings to be insured on this basis. What is much more common is insurance on reinstatement conditions.

Reinstatement conditions

This is an extension of the principle of indemnity. Cover applies on the basis, not of a discounted sum reflecting wear and tear, but the full reinstatement value at the time of reinstatement.

Under property insurance policies, there are several different types of insuring clause, the most common of which are the **reinstatement memorandum** and **Day One reinstatement**.

- **Reinstatement memorandum**. The most important aspect of insurances subject to the reinstatement memorandum is that the sum insured must represent the full value at the time of reinstatement. This means that the insured pays a premium based on the higher amount.

This particular clause allows a margin for error in estimating the sum insured. It states that the insured value must be at least 85% of the actual value otherwise claims payment will be reduced. This still leaves the insured with a problem if the claim amount exceeds the 85% figure, since insurers will not pay more than the sum insured in the event of a loss – as this effectively is **underinsurance**.

Reinstatement must be carried out without delay, though the insured is given flexibility about where and how reinstatement takes place.

- **Day One reinstatement**. Day One reinstatement requires the insured to state the reinstatement amount on the first day of the cover. Insurers provide an automatic uplift to allow for inflation (usually an extra 50% of the 'declared value') but only charge a modest increase for this inflation element (15% of the premium). The advantage of this system is that the reinstatement figure at day one is a relatively easy figure to establish. Because of this, the day one value must be accurate. There is no 15% margin for error as there would be with a reinstatement memorandum.

Day One reinstatement requires the insured to state the reinstatement amount on the first day of the cover

Consider this...

The reinstatement memorandum takes into account that a building might take two years to rebuild and the costs might increase significantly during that time. The Day One reinstatement relies on the reinstatement amount being accurate at the inception of the policy and runs the risk of the costs escalating more than 50% of that figure during the rebuild.

G5C Machinery and contents

Basic cover

The starting point for the measurement of indemnity depends on whether there is a ready second-hand market for the item.

- If there is a second-hand market then it is the second-hand price plus costs of transportation and installation that would be payable.
- Where there is not a second-hand market, it is the cost of repair or replacement less an allowance for wear and tear, if applicable.

Again it is important to emphasise that this is the starting point for considering property insurance. In practice this very limited form of cover is rare.

Reinstatement conditions

Like buildings insurances, covers for machinery and contents (other than stock) also tend to be on a reinstatement basis. This modifies the principle of indemnity. The reinstatement memorandum is a common method of insuring such items and Day One reinstatement is also possible in respect of machinery and contents. Again, it is important for you to note that the sum insured must be calculated on the same basis as the proposed settlement formula.

Covers for machinery and contents (other than stock) also tend to be on a reinstatement basis

Cash settlements under reinstatement conditions

One of the key elements of reinstatement conditions is the fact that in order to benefit from the cover the insured must actually reinstate. If no reinstatement takes place, the insured is entitled only to a settlement based upon strict indemnity. This means that wear and tear and depreciation will be taken into account and a substantially lower amount may be paid.

G5D Stock

This may be considered under two headings:

- manufacturers' stock in trade; and
- retailers' and wholesalers' stock in trade.

For more about BI policies, see chapter 3

In both cases, the insured is not entitled to payment in respect of any potential profit element on the sale of stock. This is one of the aspects that is catered for by a business interruption (BI) policy. For more about BI policies, see chapter 3.

- **Manufacturers' stock in trade**. This stock generally consists of raw materials, work in progress and finished stock. Indemnity value is the cost of raw materials, at the time and place of loss, plus labour and other costs incurred in respect of work in progress and finished stock.
- **Wholesalers' and retailers' stock in trade**. Indemnity here is the cost of replacing the stock, at the time of the loss, including the costs of transport to the insured's premises and handling costs. It is not possible to insure stock on any kind of reinstatement basis.

G5E Household goods

- **Basic cover**. In general, indemnity is based on the cost of replacing the items at the time of loss, subject to a deduction for wear and tear. However, a more popular form of cover is available and almost universally used within the UK – 'new for old' cover.
- **New for old cover**. New for old cover modifies the principle of indemnity by making no allowance for wear and tear. Most insurers retain the deduction for wear and tear for items of household linen and clothing, but apply cover for all other items on a 'new for old' basis. This is justified by setting the sum insured to represent the full replacement cost of the household goods and the premium paid reflects this. However, it does extend the principle of indemnity.

New for old cover modifies the principle of indemnity by making no allowance for wear and tear

G5F Farming stock

In the case of livestock and produce, the local market price is the basis of indemnity. Farming stock is different from other types of stock, as the insured is entitled to receive any potential profit on sale. This is because the market price is both the buying price and selling price at any time and there is no way of separating out the profit element.

G5G Liability insurance

In liability insurance, indemnity is measured as the amount of any court award (or more commonly, negotiated 'out of court' settlement) plus the costs and expenses arising in connection with the claim. Where the insurer agrees that other expenses can be incurred these are included in the amount payable. An example of such additional expenses would be the payment for specialist medical treatment following an injury.

Activity

Review a household contents policy if you can get access to one, and then speak to as many colleagues as you can who handle different types of insurance – to see what their policies say about indemnity.

G6 Modifying indemnity

We have already seen some ways in which the principle of indemnity can be modified by agreement between the parties. There are others that allow the insured to get either more or less than a strict indemnity settlement.

The principle of indemnity is modified in agreed value policies and first loss policies

The principle of indemnity is modified in agreed value policies and first loss policies.

G6A Agreed value policies

In agreed value policies the value of the subject-matter of the insurance is agreed at the start of the contract and the sum insured is fixed accordingly. This value will be reviewed at each renewal.

In the event of a claim, the value need not be proved at the time of the loss.

Agreed value, or 'valued' policies, are common in marine insurance. They may at times also be used when insuring works of art and other objects, such as vintage motor cars, whose true value may become a matter of dispute at the time of a claim. It is common to confine the agreed valuation to total losses and to provide that partial losses are settled as if the policy was unvalued, i.e. indemnifying the cost of repairs of a ship.

If, therefore, a ship is agreed to be a total loss the insurers will pay out the agreed value, even if that might be in fact in excess of the current market value of the ship, or alternatively even if the current market value is in fact far higher.

In the first example, the insured will be able to purchase a replacement vessel and have money left over, whilst in the second example, they will not have been fully indemnified as they will potentially not have enough funds from insurers to replace the ship that has been lost.

G6B First loss policies

There are occasions when the insured believes that the full value of the insured property is not really at risk, in other words, a total loss or even a very substantial loss is unlikely at least in relation to some perils that are being insured against. In this case, the insured may request that their policy has a sum insured for some perils or even all of them that is less than the full value.

Where insurers agree to this it is known as a 'first loss' policy. However, the insurer's view of the maximum amount realistically at risk is often similar to the insured's estimate. Consequently, the insurer will have calculated the premium for the full value taking these factors into account. It follows, therefore, that insurers generally only give very modest discounts on the 'full value' premium for risks insured on this basis. The reason for this is that there may only be a slight reduction in their maximum exposure and they must still pay all individual claims up to the first loss figure.

An example of this would be a factory which is spread over a large area of land. The chances of a large scale theft of raw materials would be very rare given the scale of equipment needed to actually perform the theft; however, the chance of a fire covering the whole site is more likely. In this case, the insured could obtain insurance for the full insured value for fire risks, but take a lower first loss limit on theft related risks.

It is important to understand that the insured will receive a full indemnity for the total sum insured for the perils concerned, however, the sum insured may be considerably less than the full value of the overall risk. The insured takes a risk that any loss might, in fact, be considerably larger than anticipated (for example a significant theft of raw materials) for which they might not receive enough from their insurers to replace the materials stolen.

G6C New for old cover

Activity

Review some wordings relating to classes of business that your organisation might be involved with and see if they are providing cover on a new for old basis. Consider what benefit new for old cover offers not only to the clients but to the claims personnel in working out the correct level of indemnity.

As we saw earlier, this type of cover usually applies to household contents policies. We could also place commercial property risks that are insured on a reinstatement basis in the same category. Each represents an attempt to replace at current costs.

G7 Limiting factors

There are a number of situations in which insurers may provide less than a full indemnity. This may be either because of the insured's choice of policy cover (as in the case of a first loss policy), because of poor insurance arrangements or because full cover was not requested. Policy terms may also restrict the insured's entitlement to a full indemnity.

We will now consider how the operation of the principle of indemnity can be potentially limited by the sum insured, application of average, excesses and deductibles.

G7A Sum insured

The maximum amount that can be recovered under a property insurance policy is limited to the sum insured. In liability policies, the maximum amount that can be recovered is the indemnity limit plus agreed costs. If, following a loss, the amount needed to provide indemnity is greater than the sum insured, the insured's recovery is limited to the sum insured.

Some policies have no limit stated. For example, there is no limit for third party personal injury cover in a motor policy. In such cases indemnity is restricted only by the amount of the court award (or the amount agreed in an out of court settlement), plus any other costs specifically covered by the policy.

G7B Inner limits or item limits

There are many policies that contain limits within the overall sum insured

There are many policies that contain limits within the overall sum insured. The most common of these is a household contents policy. There is usually a single item limit (for gold, silver or similar items) of 5% of the sum insured together with an overall sub-limit for all items falling into this category.

Many commercial policies will have sub-limits, perhaps for one particular location or peril being insured against such as windstorm.

G7C Average

This sum insured is the total value declared by the insured

We have said that in property insurance, the amount payable by an insurer is limited to the sum insured under the policy. This sum insured is the total value declared by the insured. It is this figure that is used to determine the premium. We have already seen that equitable premiums are central to the concept of pooling risks.

If, when taking out their policy the insured understates the value of the subject-matter of the insurance, there is said to be underinsurance. The intention is that everyone who contributes to the pool pays a premium that is based on the full value of the subject-matter of the insurance.

It would not be equitable to accept a risk into the pool that is based on less than the full value, as the premium charged would be too low. However, insurers cannot check that the sum insured is adequate every time they take on a new risk. Instead, they limit their liability by applying a policy term known as the average condition. In effect, this term means that the insured is considered to be their own insurer for the amount they have chosen not to insure if there is underinsurance at the time of any loss. It means that even partial losses will be shared between the insurer and the insured in proportion to the amount of underinsurance.

The formula used to calculate a claim payment, subject to the *pro rata* condition of average, uses the sum insured, the value at risk and the loss, as follows:

$$\frac{\text{sum insured}}{\text{value of goods at risk}} \times \text{loss}$$

The average condition is usual in commercial fire and theft policies and in virtually all household policies. It cannot apply to liability insurances.

Variations in conditions of average
The principle that losses will be paid in proportion to what the insured has decided to set as a sum insured, applies to most property insurance policies. However, insurers vary their approach in different circumstances.

Special condition of average
You will recall that the basis of indemnity for farming stock is its market value, despite the fact that this includes the insured's profit margin. Insurers also take a more flexible view of the application of average for farmers and apply the special condition of average to agricultural produce and livestock. This is because the value of both may fluctuate significantly. In the case of agricultural produce, this is particularly the case around harvest time. The effect of the clause is to state that if the value at the time of loss represents at least 75% of the actual value, average will not be applied. The condition does not apply to items that relate solely to growing crops, fences, gates and boundary walls, household goods or overhead cables or poles and the standard 'average' condition would apply to such items. (There may also be an option for the insured to insure for the 'forward price' of produce. In this case, in the event of loss or damage, the value could not be ascertained until the forward date chosen has been reached.)

Two conditions of average
These conditions are designed to apply to contents or stock, the insurance of which is arranged on a floating basis (in more than one location), where specific insurance also applies. The effect of the wording of these conditions is first of all to state that 'average' applies. However, it goes on to state that if there is a more specific insurance for the items insured at any of the locations, only the excess value will be used to check whether average applies.

Question 2.6

A fire is suffered in a factory and the surveyor appointed by the insurer reports that the factory was worth £1,000,000 before the loss. The policy says that the factory has been insured for a value of £800,000.

If the claim is otherwise valid and presented for £500,000, how much will the insurer deduct for average or underinsurance?

Average

Average means 'underinsurance' in non-marine insurance but only means 'loss' in marine insurance.

G7D Excess; deductible; franchise

An excess is an amount that is deducted from each claim and is paid by the insured.

An excess is an amount that is deducted from each claim and is paid by the insured

Some excesses are compulsory, such as the excesses that apply to UK motor insurance policies for damage to the insured vehicle when young or inexperienced drivers are in charge of the vehicle.

Most excesses are voluntary and this is the case with commercial policies. This means that the insured receives some premium reduction for agreeing to carry the excess.

There is a lack of consistency in the market regarding the use of the term deductible. Historically, a deductible was a large excess – and this remains one of its definitions today. This would be the case where a commercial organisation agrees to meet the cost of any claim falling within the policy terms, up to the stated value of the deductible.

What may confuse you is the fact that sometimes the two terms 'excess' and 'deductible' appear to be used interchangeably in the market.

In general, policies that contain an excess will pay up to the policy limit over and above the excess; basically building a tower of policy limits above the value of the excess. However, where the policy refers to a deductible, this amount is deducted from the limits – so unless the policy wording overrides the basic principle, the insured will never be paid the full policy limits. Even this usage is not universal, but it serves to distinguish the terms as a general rule. It is therefore very important to ascertain exactly how the term is being used to identify the amount of the policy available for the payment of any claims.

If there is underinsurance or any other policy term that limits or reduces a loss, and an excess or deductible applies to the same loss, the excess or deductible is deducted last of all.

Where the policy refers to a deductible, this amount is deducted from the limits

A franchise operates in the same way as an excess or deductible as it is the first amount of any claim that the insured must pay themselves. However, it differs once the claim value exceeds the franchise value. Once this happens, the insurers will pay the whole claim with the insured not having to pay anything. Franchises are rare in the market these days but it is important to be aware of them just in case they are seen.

Example 2.5

Policy with limits of US$ 1m and a 'deductible' of US$ 100,000.	Insurers will only ever pay US$ 900,000 any one loss and the insured will pay US$ 100,000 (plus any amount over and above US$ 1m).
Policy with limits of US$ 1m and an 'excess' of US$ 100,000.	Insurers will pay up to US$ 1m any one loss and the insured will pay US$ 100,000 plus any amount over and above US$ 1m.
Policy with limits of US$ 1m and a 'franchise' of US$ 100,000.	If claim exceeds franchise level, insurers will pay up to US$ 1m and the insured pays nothing (except if claim exceeds US$ 1m).

H Contribution

There are some situations in which an insured may have in place more than one policy covering a particular loss or liability. Circumstances may also arise where the policyholder has insured a risk but the loss, when it happens, is caused by the actions of a third party. Consequently, not only is the policyholder protected by the insurance, they also have the potential to recover damages from the third party.

In the first case we need to look at the rules that apply where there is some kind of dual insurance (under the principle of **contribution**); in the second we need to see how the insured's rights of recovery are passed on to the insurer (the principle of **subrogation**).

Underlying both these principles is the principle of indemnity, which relates to exact financial compensation. This means that the insured is not entitled to profit from a claim settlement.

When we examined the principle of indemnity, we said that when settling a loss, the intention was to place an insured in the same financial position they enjoyed immediately before the loss.

We also said that the insured cannot recover more than the financial loss suffered. The insured can take out as many insurance policies as they wish, provided that there is no fraudulent intent. But what happens when there is double insurance with more than one valid policy in force? Can an insured recover under both policies and hence receive more than they actually lost?

From our study of the principle of indemnity, we know that an insured should not be able to recover, in total, more than the amount lost by claiming under both policies. The insured can only recover the total amount of a loss sustained, regardless of the number of policies held.

Let us consider an insured who holds two policies for the same subject-matter (say their private motor car). If they then make a claim under one of the policies and receive indemnity from such policy, the other insurer has avoided its financial responsibility to the insured. The insurer that paid the claim has taken full financial responsibility for the loss. It is this possibility that gives rise to the principle of contribution, which seeks to share the burden of the loss fairly among all insurers who cover the loss.

H1 Double (or dual) insurance

The role of brokers is covered in chapter 8

There are many situations where double insurance could exist but it rarely occurs in commercial insurances due perhaps to the more sophisticated nature of the buyers and the use of brokers.

The most frequent example of double insurance is a person going on holiday and buying travel insurance not realising that their household contents insurance could well provide cover for items such as cameras and sunglasses whilst away from the property.

H1A Contribution condition

If there is no specific policy condition, the insured is entitled to claim the whole amount from any of the insurers that are liable to pay

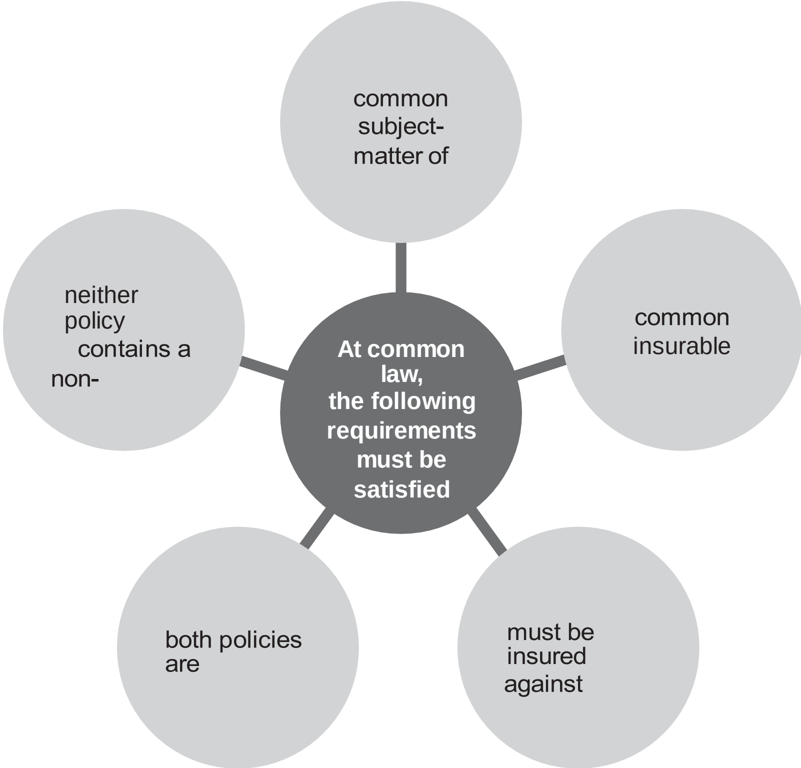
Contribution supports the principle of indemnity, and so it exists whether stated in a policy document or not. However, if there is no specific policy condition, the insured is entitled to claim the whole amount from any of the insurers that are liable to pay. This effectively leaves that insurer to recover appropriate shares of losses paid from the other insurers. Therefore, insurers customarily include a contribution condition in their policies. This condition restricts the insurer's liability to its **rateable proportion** or **rateable share** of a loss.

The effect of the condition is to compel the insured to make a claim under each valid policy for the sum for which each insurer is liable if they wish to receive a full settlement.

H1B Definition of contribution

Contribution is defined as 'the right of an insurer to call upon others similarly, but not necessarily equally, liable to the same insured to share the cost of an indemnity payment'. Let's consider how and when contribution arises.

H1C How contribution arises



There is no requirement for the policies to be identical, but there does need to be some overlap between them.

Common insurable interest
In other words, the insurable interest is the same (owner, user, bailee etc.). This principle was established in the case of ***North British and Mercantile v. Liverpool and London and Globe* (1877)**, known as the ***King and Queen Granaries*** case.

In this case, a merchant had deposited grain at a granary owned by Barnett. By virtue of the custom of his trade, Barnett had insurable interest in the grain and had insured it accordingly. The owner had also insured the grain to cover his own interest in it.

The grain was damaged by fire and Barnett's insurers paid the whole claim. They then sought to recover from the owner's insurers. However, it was held that, as the two insureds' interests were different, one as bailee (Barnett, the granary owner) and one as owner (of the grain), contribution did not apply. Barnett's insurers bore the whole loss.

This raises the question of whether both parties may claim under their policies if the interests in the same loss are different. In theory, both insureds could recover but, in practice, the insurance market has reached an agreement to protect itself from paying out twice on the same loss.

Common peril
The peril which causes a loss must be common to both policies. Let us consider a situation where we have two policies: one covering dishonesty and the other covering dishonesty, fire and burglary. These can be brought into contribution where the loss is due to dishonesty. However, this is not the case where the loss is due to fire only since this peril is not common to both policies. The insurer covering fire bears the burden for the loss in these circumstances.

The peril which causes a loss must be common to both policies

Common subject-matter
The subject-matter being insured, whether it be a physical object or the risk of being held liable for something must be the same across both policies.

The subject-matter being insured must be the same across both policies

H1D Application of the principle of contribution

We will now consider different methods of applying contribution. Insurers contribute to a claim on the basis of what is termed a **rateable proportion**.

Rateable proportion

Rateable proportion is the share of any claim that an insurer pays when two or more insurers cover the same risk; usually in proportion to the respective sums insured

Rateable proportion is the share of any claim that an insurer pays when two or more insurers cover the same risk; usually in proportion to the respective sums insured. Two possible ways of determining the rateable proportion of a claim include:

- sum insured; and
- independent liability method.

By sum insured

One method of calculating the rateable proportion of a loss is by apportioning it in line with the **sums insured** under each policy. The rateable proportion is calculated using the formula:

$$\frac{\text{policy sum insured}}{\text{total value at risk}} \times \text{loss}$$

By independent liability

An alternative method for calculating each insurer's share of a loss is the independent liability method

An alternative method for calculating each insurer's share of a loss is the independent liability method. This method calculates the amount payable under each policy as if no other policy existed and the insurer was alone in indemnifying the insured. The loss is then shared in proportion to the independent liabilities of the two policies.

This method is used where property policies are subject to average or where an individual loss limit applies within a sum insured. Independent liability is also the method used for calculating contribution in liability insurances. The formula used is:

$$\frac{\text{policy sum insured}}{\text{total sum insured (all policies)}} \times \text{loss}$$

eg

Example 2.6

Two policies cover a cargo of sugar against water damage.

Policy 1 has sum insured of £100,000 and Policy 2 has sum insured of £30,000.

Damage to the cargo is £60,000 (average will be ignored for this example).

Policy 1 can pay the full £60,000 but Policy 2 can pay a maximum of £30,000.

Policy 1 can pay twice the amount of Policy 2 so will pay 2/3rds of the claim and Policy 2 1/3rd.

Policy 1 pays 2/3rds of £60,000 which is £40,000 and Policy 2 pays £20,000.

Modifications to the principle

There are some situations in which the principle of contribution is modified.

- **Non-contribution clauses**. Certain policies have what is known as a non-contribution clause. This may be worded as follows: 'This policy shall not apply in respect of any claim where the insured is entitled to indemnity under any other insurance.'

  This means that the policy would not contribute if there was another insurance policy in force. The courts do not favour such clauses, and in situations where a similar clause applies to both (or all) policies, they are treated as cancelling each other out. This means that each insurer would contribute only its rateable proportion.
- **More specific insurance clauses**. Certain policies include a clause which restricts cover in situations where a more specific insurance has been arranged. The most common example of cover being restricted in this way is in a household policy. The reason for this is that many householders arrange specific insurance for jewellery and other items, and it is not the intention for both policies to contribute.
- **Market agreements**. There are many market agreements which operate to smooth the path of contribution settlements. One example is an Association of British Insurers (ABI) agreement that applies when there is an overlap between travel, all risks, household and the personal effects section of a motor policy. The agreement states that insurers will not insist that the insured claims a proportion from each insurer where the sum involved is modest, regardless of what the policy conditions actually say.

I Subrogation

We can summarise subrogation as **the right of an insurer following payment of a claim, to take over the insured's rights to recover payment from a third party responsible for the loss**.

Subrogation is limited to the amount paid out under the policy.

Subrogation is limited to the amount paid out under the policy

The insured cannot claim an indemnity payment from an insurer and then also acquire a further payment from a negligent third party. This would result in a profit to the insured and would breach the principle of indemnity.

However, the requirement that the insurer must already have indemnified the insured before pursuing subrogation rights, gives rise to some problems. This is because the insurers would not have had complete control of proceedings from the date of the loss. Its eventual position could be severely prejudiced by delay – maybe evidence or witnesses would no longer be available.

In order to gain this control, insurers invariably include a condition in the policy which gives them the power to pursue subrogation rights before the claim is paid. The only limitation is that the insurer cannot recover from a third party before it has actually settled its own insured's claim.

Be aware

Do not forget that the concept of indemnity is to place the insured in the financial position they were in immediately before the loss.

Reinforce

An insurer provides a property policy for a factory which covers fire. A fire breaks out in the factory and the surveyor advises that the likely cause is some welding work being done by an external contractor.

The insured could just seek financial compensation from the contractor; however, it is easier to claim on their property insurance.

They must put the contractor on notice that they will also be pursuing them for damages. The insurer will be involved in discussions with the contractor but cannot obtain money from them until the insurance claim has actually been paid. Of course, the contractor could also have a claim made against them by the insured for any deductible or excess they have had to pay – this could be quite a significant amount.

I1 Definition of subrogation

Subrogation is the right of one person, having indemnified another under a legal obligation to do so, to stand in the place of that other and avail themselves of all the rights and remedies of that other, whether already enforced or not.

In keeping with the principle of indemnity, insurers are also not entitled to recover more than they have paid out.

In keeping with the principle of indemnity, insurers are also not entitled to recover more than they have paid out

This is seen in the case of ***Yorkshire Insurance Co. v. Nisbet Shipping Co. Ltd* (1961)**. In this case, the insurers made a settlement of £72,000. However, there was a long period of time between the payment of the claim and the recovery from the third party and there had been changes in the rates of exchange. Consequently, the insured actually recovered £127,000. It was held that the insurers were only entitled to £72,000. The insured was entitled to the balance.

I2 Insurers' subrogation rights

Let's consider how the rights that insurers can take over will arise.

I2A Tort

At common law, everyone has a duty to act in a reasonable way towards others. A breach of this duty is called a **tort**. The person who has suffered damage or injury is entitled to compensation. For example:

At common law, everyone has a duty to act in a reasonable way towards others

- someone crashes into the wall of your property in a vehicle and knocks it down;
- a neighbour lets their property become unsafe and when a chimney collapses it damages your property; or
- another ship crashes into yours whilst you are moored in port.

You can arrange an insurance policy to cater for each of these events. As well as the indemnity for the physical damage which insurers provide, the insured has a right (in tort) to financial compensation from the individuals involved in the wrongdoing. The insurers assume the rights of the insured and attempt to recover their outlay from the wrongdoer.

Under certain contracts, a breach of contract entitles the aggrieved party to compensation, regardless of fault. Insurers can assume the benefits of these rights – their rights, however, can never be better than the insured's would have been.

?

Question 2.7

Insurers' rights to claim against a third party having indemnified the insured are called:

a. Contribution ☐
b. Subrogation ☐
c. Consideration ☐
d. Representation ☐

I2B Statute

Where insured property is damaged as a result of riot, the **Riot (Damages) Act 1886** comes into play. This Act means that, where an insurer has indemnified their insured for damage suffered in this way, it can recover its outlay from the police authority of the district in which the riot occurred. Insurers may sue in their own name in this instance, but have only 14 days from the date of the riot to do so. It is for this reason that some insurers have written a seven-day reporting requirement for such losses into their claims notification conditions.

The **Riot Compensation Act 2016** repeals the 1886 Act and makes provision for types of claims that can be made against the police and the procedures for making them in relation to property damaged, destroyed or stolen in the course of riots. It came into force on 6 April 2017.

I3 Other rights of insurers to recoup some of their outlay

In some types of insurance, a total loss under the policy will be offered to the insured when the subject-matter of insurance is not completely destroyed but is perhaps so badly damaged that the repair costs will exceed the sum insured.

Residual value in the sum insured is called 'salvage'

Of course, when this happens there may be some residual value in the item insured. This is termed **salvage**. If the insurer meets the loss in full it is the insurer that is entitled to the benefit of the salvage value.

Because it is a financial benefit, a question arises as to who has rights to the salvage itself. The insured has the opportunity to retain the salvage, provided a suitable deduction is made from the claim payment to take its value into account. The amount needs to be agreed between the insurer and the insured.

This principle governs the recovery of property. For example, if an insurer pays out a sum as a total loss for an item of jewellery that has been stolen and it is subsequently recovered, the insured must be offered the recovered jewellery provided that the full claim payment is repaid to the insurer.

In an important respect, the rights arising from salvage differ from subrogation rights. When the insurer retains the salvage, the insurer becomes the owner of it. If, when salvage is sold, a greater sum is achieved than the insurer originally assumed, this is in order.

Market agreements

There are many situations in which, by virtue of the operation of subrogation, insurers would be corresponding about money that they would need to claim back from each other.

Example of a market agreement is the immobile property agreement

A limited number of market agreements exist to reduce the correspondence and administrative costs involved in pursuing frequent subrogation procedures. One example is the **immobile property agreement**.

In the past, some motor and property insurers operated the immobile property agreement. It covered impact damage by motor vehicles. Whenever a vehicle collided with a building this agreement meant that each insurer would contribute towards the loss in the proportions already agreed. The agreement is now virtually at an end as far as insurers are concerned, though it still remains in force between certain insurers and local authorities.

I4 Precluded subrogation rights

There are some situations in which insurers are barred from exercising subrogation rights, or where they agree not to exercise them.

I4A Insured has no rights

The insurer's right to subrogate relies on the insured having rights against a negligent party which the insurer takes over, having indemnified the insured. It could be that the insured entered into a contract with the negligent party which precluded any subrogation rights arising. These are often known as '**mutual hold harmless**' agreements where each side agrees to deal with their own damage and injuries and not claim against the other.

I4B Benefit policies

As we have established, certain policies, such as personal accident policies, are benefit policies.

These policies are not true policies of indemnity as it is impossible truly to put a person back in the position they were in before the loss when the loss involves a part of the body. It, therefore, follows that even if a person negligently causes an accident in which the insured is injured, the personal accident insurer will have no right of recovery. This is true even if the insured successfully sues the negligent third party and receives financial compensation for the injuries.

The insured is entitled to keep both the personal accident benefits and the court award.

Reinforce

Aviation loss of licence insurance exists to replace income for pilots who lose their licence usually because they fail a medical examination. If this failure comes about because of injuries sustained in a car accident, the insurer cannot claim against the responsible driver in subrogation, however, the injured pilot can, and keep any award made as well as the insurance payout under their loss of licence policy.

I4C Subrogation waiver

Subrogation waiver clauses are common in commercial insurances

There are circumstances in which insurers agree to waive their rights of subrogation. They do this through subrogation waiver clauses, which are common in commercial insurances. These clauses are usually designed to prevent the insurer from pursuing any subrogation rights it may have against a parent or subsidiary company of the insured.

I4D Negligent fellow employees

Insurers took the decision not to pursue their recovery rights against negligent fellow workers as a result of a court case, ***Lister v. Romford Ice and Cold Storage Ltd*** **(1957)**. The details of this case are that a son injured his father in the course of his employment (they were fellow workers). The insurers paid out for the father's injuries under the employer's liability policy.

They then successfully recovered their outlay from the son (because his father's injuries were the result of a lack of reasonable care on his part). There was criticism of the insurance industry and a general feeling that this was harsh. Insurers have therefore generally agreed (except in extreme circumstances) not to pursue recovery rights against negligent fellow workers.

Key points

The main ideas covered by this chapter can be summarised as follows:

Contract law

- Several key ingredients without which a valid contract will not be created such as offer, acceptance and consideration.

Consideration

- This is the promise to pay the claim on the part of the insurer and the promise to pay and payment of the premium on the part of the insured.

Insurable interest

- Having a relationship with the subject-matter of the contract (be it a physical thing or a liability) which could lead to financial loss if it is damaged or causes damage to others.
- Insurable interest does not require ownership.

Duties relating to the information shared by the insurer and insured during contract negotiation

- Good faith is a two-way concept whereby both insured and insurers have to disclose material information to each other.
- The Consumer Insurance (Disclosure and Representations) Act 2012 covers the obligations of the parties in consumer insurance and the Insurance Act 2015 non-consumer insurance.

Cancellation of insurance contracts

- If there is a deliberate breach of the duty of disclosure, then the other party can decide whether to cancel the contract.
- If there is a lack of a vital ingredient of the contract such as offer or acceptance, then the contract will never actually exist.

Proximate cause

- The most powerful operative cause of loss, not necessarily the last thing to happen.

Indemnity

- Putting the insured back in the same financial position as they were in prior to the loss.
- Indemnity is not necessarily done through a cash payment; it could be repair, replacement or reinstatement.
- Certain policies such as health and accident policies are benefit policies not indemnity policies as a value cannot be put on a limb or a sense. A scale of benefits is used to work out the payments made.

Contribution

- Where two or more policies cover the same item for the same risk then they should share the loss between them in a rateable manner.

Subrogation

- The right of the insurers to claim against a responsible third party having first indemnified the insured.

Question answers

2.1 The correct answer is c.

2.2 The correct answer is d.

2.3 The correct answer is b.

2.4 Falling from the horse.

2.5 The correct answer is c.

2.6 £100,000 which is 1/5th of the claim as the risk is only insured for 4/5ths of its value.

2.7 The correct answer is b.

Self-test questions

1.	What are the three most important essentials of a valid contract?
2.	What is the consideration for an insurance contract?
3.	What is insurable interest?
4.	What is good faith? Give an example.
5.	What is misrepresentation? How does this differ from non-disclosure?
6.	What is meant by proximate cause?
7.	What is meant by indemnity?
8.	What are the two methods – other than reinsurance – where an insurer can claim money back from other parties?
9.	What are the two main terms used for the first part of any claim payable by the insured?
10.	What is a reckless breach of the duty of fair presentation?

You will find the answers at the back of the book

3

Main classes of business written in the London Market

Contents	Syllabus learning outcomes
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B Non-marine insurance	3.1, 3.2
C Aviation insurance	3.1, 3.2
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Answers	
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Learning objectives

After studying this chapter, you should be able to:

- describe the main classes of business written in the London Market;
- describe the main features of the different classes of insurance;
- explain what reinsurance is and why it is used;
- state the main buyers and sellers of reinsurance; and
- describe the main terminology used in reinsurance.

Introduction

In this chapter, we will be reviewing the key features of the main classes of business written in the London Insurance Market. More detail of the perils covered in each class can be found in study text *LM2: London Market insurance principles and practices*.

We will start with marine insurance, followed by non-marine, aviation and reinsurance. Interestingly, some specific types of insurance could be described as both marine and non-marine – as you will see later in the chapter.

Key terms

This chapter features explanations of the following terms:

Advanced loss of profits (ALOP)/delay in start-up (DSU) insurance	Aviation insurance	Business interruption (BI) insurance	Cargo insurance
Cedant	Contractors all risks (CAR) insurance	Employers' liability insurance	First party insurance
Goods in transit insurance	Marine insurance	Mutuals	Non-marine insurance
Motor liability insurance	Particular average	Personal accident insurance	Personal illness or sickness insurance
Political risks insurance	Products liability	Professional liability insurance	Property insurance
Public liability insurance	Reinsurance	Retrocedant	

A Marine insurance

Marine insurance as its name suggests generally has some connection with the sea – and it is fair to say that the sea is a common denominator when looking at the types of insurance included in this classification. One word of warning, as we will see, marine insurers are quite prepared to cover risks that having nothing obvious to do with the sea. This is not done to encroach on the work of their non-marine colleagues, rather that they have historically been more willing to extend the boundaries of their natural areas of specialism.

There is additionally an unusual historic practice in the marine market of writing insurance in situations where the purchaser's insurable interest is not entirely clear. The lack of clarity may be around the interest itself or the financial extent of the interest (i.e. how much a vessel is actually worth).

Insurable interest is required for an insurance policy that is valid in law, so these policies are known as honour policies (i.e. not enforceable in a court). The term 'or Policy Proof of Interest' (or 'PPI') is used to identify them, i.e. the mere possession of a policy is evidence of the purported insurable interest.

These policies are rare in practice but passing reference is made to them in certain wordings still used in the market today.

A1 Hull and yacht/recreational vessel insurance

Ships come in various shapes and sizes from the very smallest personal recreational craft such as a dinghy, up to the largest oil tanker or container vessel. Ignoring their size, they have broad similarities in shape and design and actually face the same perils when out on the water.

Yacht insurance covers a vast range of different vessels, as follows:

Yacht insurance covers vessels such as sailing vessels, motor vessels and inland vessels

Sailing vessels	ranging from high specification racing vessels, through the fleets which are used for cruising holidays to the smaller owner operated boats.
Motor vessels	ranging from the super vessels owned by the very wealthy, through the cruisers used for holiday bookings, to the owner operated. Motor vessels can vary widely in the nature of the propulsion machinery used in them which also varies the nature of the risk.
Inland vessels	such as canal boats.

Activity

Visit www.fraseryachts.com to see the different types of vessel that could appear in a yacht account.

Commercial vessel insurance also covers a large range of different types of vessels such as:

Cargo vessels	Vessels carrying all types of goods ranging from bulk minerals in solid and liquid form, vehicles, refrigerated goods to containers. These vessels range greatly in size depending on the shipping routes that they are operating, with smaller vessels used for shorter, coastal voyages and larger vessels sailing what is known as the deep sea trades.
Cruise/passenger vessels	Medium to large vessels used for holiday purposes, often carrying large numbers of passengers. Ferries operate in most parts of the world carrying people, their vehicles and some goods across waterways of varying sizes.
Specialist vessels	Vessels such as cable layers, survey ships, drilling ships and heavy lift vessels. These ships are all constructed to perform certain key tasks which expose them to different risks to other general cargo-type ships.

The key common element that is covered by any type of marine hull insurance is damage to the insured ship which makes this a physical loss or damage type of insurance. This type of insurance is also known as **first party insurance**.

This term is not confined to marine insurance – any physical damage insurance covering the insured property is first party insurance. In marine, there is a special term used for physical damage to the insured property which is 'Particular Average'.

Under most of the policy wordings there is also coverage for the liabilities that arise under maritime law should the insured vessel collide with another vessel. In the event that this occurs, maritime law essentially provides that each side has to pay damages to the other ship that relate to its share of the blame. Each side can then make a claim with their hull insurers for that amount, in addition to any damage suffered by their own vessel.

Example 3.1

Two ships (1 and 2) collide. After looking at the evidence, they agree that Ship 1 was 60% to blame and Ship 2 was 40% to blame.

Ship 1 has £100,000 worth of damage to her hull. Ship 2 has to pay £40,000, being 40% of £100,000.

Ship 2 will make a claim on her hull insurance policy for her collision liabilities.

When the claim is made on the insurance policy, it is important to remember that irrespective of the insured's obligations to any other party in law, its claim will still be handled according to the policy wording. Therefore, the insured will normally have to pay a deductible or excess, rather than the insurers paying everything.

A1A Builder's risk insurance

The construction of a vessel (irrespective of her size or eventual use) is an expensive and lengthy process both for the eventual owner and the builder. Builder's risk insurance provides a combined physical damage and liability cover where the insureds can be just the purchaser/owner or a combination of the purchaser/owner and the build yard. The key aspects of the insurance are the length of time of the process but also the increasing values as the building progresses through to completion and handover to the owner.

Activity

Ask your colleagues if your firm handles marine hull or yacht business. If it does, try to find out what types of vessels are involved – and whether you specialise in a particular type.

A2 Loss of earnings insurance

If a shipowner cannot use a ship because it has been damaged, then they cannot earn money from it. If the ship is their sole source of income then this could be a major problem for them. They can, therefore, purchase insurance covering their loss of earnings, because either they cannot carry passengers, or use the vessel for carrying cargo, or hire the vessel out to others.

The insurance will require some physical damage to have occurred to the vessel and it is important that this insurance does not cover loss of earnings merely because there is no work for the vessel to do (this would be a business risk and not insurable).

> If you do not remember about business risk being uninsurable, review chapter 1 now to refresh your knowledge of insurable and uninsurable risks.

As we will see in section B2, the concept of loss of earnings also appears in non-marine insurance where it is generally described as business interruption (BI) insurance.

In both types of loss of earnings insurance, the way in which the policy limits and deductibles are expressed differ from physical damage policies. Instead of a financial deductible or excess, loss of earnings policies generally have waiting periods.

This means that the insured has to wait a period of days from the first day of their inability to earn – once that period has expired they can claim from their insurer.

Policy limit for loss of earnings is usually expressed as a period of days

Generally, the policy limit is also expressed as a period of days. Of course, there are some financial provisions within the policy (for example, a maximum indemnity payable per day of coverage). This figure is calculated using the information provided by the insured concerning their business – for example their wages bill and any regular (fixed) payments for rent or rates.

Typical loss of earnings policy

A typical loss of earnings policy will provide for 150 days' indemnity, after a waiting period of 14 days.

Question 3.1

A ship used for pleasure trips down the Thames is damaged by colliding with Tower Bridge. The repairs are going to take four months. The shipowner will claim for the repairs to the ship from their hull insurers but against which other policy can they claim?

a. Liability insurance purchased by Tower Bridge ☐
b. Their loss of earnings policy ☐
c. They will claim everything from their hull insurers ☐
d. Their reinsurers ☐

A3 Cargo and goods in transit insurance

Cargo can be translated as goods

Cargo can be translated as goods; however, in the context of insurance, there is a key difference between cargo and goods in transit insurance. Cargo insurance is physical damage insurance for the items being moved around, whereas goods in transit insurance is primarily liability insurance for the person or organisation moving the items around; it covers some damage to their own property but mainly their liabilities in case they damage the cargo in their custody or care.

A3A Cargo insurance

Between 90% and 95% of world trade is still conducted by sea

Even with the rise of road, rail and air cargoes, between 90% and 95% of world trade is still conducted by sea – resulting in a large demand for marine cargo insurance. Marine cargo insurers will, in fact, insure journeys by road, rail and air as well as sea.

This insurance covers physical damage to the goods whilst they are on their journey. However, unlike hull insurance for ships, the standard cargo insurance does not cover any liabilities for the cargo damaging any persons or their property.

Many modern-day journeys are undertaken using various types of transportation, such as road, rail and sea, or road and air; therefore, it's important to ensure that the insurance remains in force throughout the intended journey and does not stop prematurely. Cargo insurers generally prefer the items to be moving almost continuously during the transit, although they recognise that a container, for example, might stop in a port for a couple of days between being discharged from a smaller local vessel and being loaded onto a larger vessel for the deep-sea journey.

Cargo insurers do not anticipate insuring storage-type risks as they are of course static in nature

Cargo insurers do not anticipate insuring storage-type risks as they are of course static in nature; however, there is a specific type of insurance written in the cargo market which deals with this very issue – stock throughput insurance.

A3B Stock throughput insurance

Stock throughput insurance is an end-to-end product which combines a transit policy with storage policies thus removing the danger of gaps in coverage between a freestanding storage policy generally written by property/inventory insurers and a transit insurance written by cargo insurers. They are generally written in the marine market and offer significant benefits to any client whose business necessitates their goods – both moving and being held in storage for any given length of time.

Question 3.2

A clothing retailer has a significant supply of clothes that are held in warehouses and then moved to the various shops they have around the country. What is the most appropriate type of insurance to purchase to cover these items?

a. Cargo insurance ☐
b. Property insurance ☐
c. Stock throughput insurance ☐
d. Goods in transit insurance ☐

A3C Jeweller's Block insurance

As its name suggests, 'Jeweller's Block' insurance is specifically aimed to cover the jewellery trade. This was one of the first non-marine areas of insurance introduced into Lloyd's by Cuthbert Heath in the late nineteenth century. It is often set up as a package policy covering many different property and liability type risks and can cover all aspects of the business from the manufacturing, through trade shows and exhibitions and finally retail risks. It is perhaps difficult to see how this links in with the marine market and in fact this is one of the classes of insurance that can just as easily be written in the non-marine market.

'Jeweller's Block' insurance is specifically aimed to cover the jewellery trade

There are also transit risks regarding moving the insured items to and from trade shows. Items moved between various jewellers must be done so in accordance with the practices of the jewellery trade.

This again is a physical loss or damage-type insurance; however, the key elements that are generally excluded are mysterious disappearance and inventory losses, given the size and appeal of the items being insured.

A3D Specie insurance

Specie insurance is also a physical loss or damage insurance but the items covered are:

- loose gemstones;
- precious metals, such as gold and silver; and
- valuable documents.

Documents are not something that we would necessarily think about as having value. Examples include tickets, vouchers and even cheque books (although less common in the 'plastic generation').

In the case of documents, the insurance will cover the cost of reconstructing the documents should they be lost or damaged (for example, by fire or water).

This is another example of insurance that is written in the cargo market but which could equally well be written in the non-marine market.

A3E Fine art insurance

Fine art insurance covers paintings, items such as sculptures and those objects which are generally called 'installations' – which could involve just sound or light rather than a tangible painting on the wall. As with the examples earlier in this section, this is also a type of physical loss or damage insurance. One of the elements of cover is not only the cost of repairing any item that has been damaged but also paying out for depreciation in the value as a result of having been damaged.

Fine art insurance covers paintings, items such as sculptures and 'installations'

Activity

Read the article at www.msnbc.msn.com/id/15310601/ to see how easy it is to damage paintings and what it can cost.

Chapter 3

The insureds include museums and private collectors

The insureds include museums and private collectors. The insurance will cover both the static risk whilst in the gallery or museum as well as any transit between collections or to exhibitions.

Since art valuation is quite subjective, it is often the cause of disagreement between the insurer and insureds; therefore, several expert opinions are required.

Activity

If any fine art is displayed at your office, find out if and where it is insured.

Find out if there have ever been any losses.

A3F Satellite pre-launch insurance

The word 'satellite' appears quite out of place here but it is in the right place as the cargo market does get involved with the insurance of satellites at a point before they are sent into space. Satellites moving from the manufacturing facility to the rocket launch pad are just another piece of cargo moving from one place to another, albeit a very expensive and very delicate one. Cargo insurers cover the satellite for physical loss or damage until the launch insurer takes over.

When does the launch insurer take over? The wordings of policies differ slightly but the broad concept is that the satellite pre-launch (cargo) insurer comes off risk when the engines are intentionally ignited. The launch insurers are in the aviation and space market.

Consider this…

Who will be on risk if the engines accidently fire and the satellite is destroyed?

Further information about aggregation can be found in study text LM2

Aggregation is an issue for all insurers, i.e. the accumulation of insured items in one place where they can be exposed to the same perils. This is also the case with satellite pre-launch insurance where the rockets will often be launching more than one satellite at once, so both the pre-launch (cargo) insurer and the launch insurer are going to be paying close attention to the number of satellites they are insuring on any one rocket – just in case something does go badly wrong. Further information about aggregation can be found in study text *LM2*.

A3G Cash in transit insurance

Cash in transit is another area of insurance which is also written in the non-marine market as well as the cargo market. It covers the movement of money between locations. For example:

- Banks move money between head offices and local branches.
- Banks move money between bank premises and remote Automatic Teller Machines (ATMs).
- Companies move funds from their premises to their banks.

Underwriters impose various key risk prevention criteria in the policy terms

This insurance covers loss or damage to the cash, which as you can imagine, is a very appealing cargo for thieves to target. Underwriters impose various key risk prevention criteria in the policy terms such as:

- varying routes;
- mixing up the truck crews to avoid the 'inside job' (whereby the insured's personnel are not entirely honest and pass information about the shipments to outsiders);
- armed truck crews;
- using global positioning satellite (GPS) and other sensors to allow trucks to be tracked if stolen;
- safety measures whereby paper money is soaked in water and dyes should anyone try and break into the cases they are carried in, thus rendering the money useless; and
- warranties in respect of (not) leaving vehicles unattended.

Activity

Look at this website and see how technology is working to help find any thieves!

www.smartwater.com

A3H Goods in transit insurance

This insurance covers the liability of the carrier in respect of the goods being carried. This insurance generally does not cover sea carriers as they obtain their liability insurance elsewhere using more wide-ranging liability policies. The types of exposure that the policy covers include not only loss or damage to the goods being carried but also matters such as the releasing of the cargo at destination to the wrong party.

Liability claims are also called third party claims, as opposed to the physical damage policies which lead to first party claims.

> **The parties involved in insurance**
> In an insurance contract, the insured is the first party, the insurer the second party and anyone else is a third party. In a liability situation, the policy is being triggered by a claim on the insured by someone else, which is why they are called third party claims.

The insurer considers the following questions when considering a goods in transit risk:

- What is the nature of the insured's business?
- What controls need to be in place to ensure the insured cargo is well looked after during the transit?
- Does the insured have its own fleet of vehicles which are well maintained?

A4 War and strikes insurance

Both 'war and strikes' (which actually includes terrorism in the main wordings) are excluded from the main hull, cargo and marine liability policies. However, marine war and strikes insurance is fairly freely available within the London Market, but the main market wordings are not quite as broad as the exclusions they are replacing.

Both 'war and strikes' are excluded from the main hull, cargo and marine liability policies

War insurance covers war and civil war type risks, together with captures and seizures and the damage that might be caused by abandoned mines or similar ancient weapons. Piracy is specifically not included as a war risk in the main London Market wordings and is covered as a main peril in the hull wordings and in the widest of the cargo wordings. However, hull insurers will often move the peril under war insurance to keep all similar risks together.

Strikes insurance covers both strikes and damage caused by terrorists or those acting from a political or religious motive.

> **Definition of a strike**
> A strike is defined in English law as 'a concerted stoppage of work', which requires planning and action. It is possible to have industrial action short of a strike such as refusing to work overtime, which if you are not contractually obliged to work then cannot be a stoppage of work.

One of the reasons that this kind of insurance is freely available is that marine risks are generally expected to be mobile and hence able to move out of danger should it arise. In practice, insurers use cancellation wordings to allow them to cancel and immediately reinstate the policy as required. They take the opportunity to amend the policy terms and conditions, imposing increased premiums for any voyages into areas considered at any time to be more dangerous.

Marine risks are generally expected to be mobile and hence able to move out of danger should it arise

The areas of the world where these additional premiums have to be paid vary according to the prevalent political situation.

> **Activity**
> Which areas of the world do you think insurers might consider more dangerous at the moment – from a marine war perspective? Ask your senior colleagues for their opinion.

A5 Marine liabilities

Just as a shipowner can purchase insurance against physical loss or damage to their ships, they should also consider purchasing insurance in case they incur any legal liabilities by injuring someone else, or their property.

As we saw earlier, hull insurers include an element of liability insurance in their policy, i.e. liability arising from a collision with another vessel. However, this coverage is quite restricted and hence other liability insurance would be a prudent purchase.

We will now look at some examples of the types of liabilities that marine-related industries can incur. Note, however, that the list is not exhaustive.

Vessel owners and operators should purchase insurance in relation to their liabilities for:

- Injury or death of crew.
- Injury or death of other visitors to the vessel who are not crew, for example, the port chaplain.
- Pollution caused by escape of cargo, waste water or the vessel's fuel.
- Damage to the cargo being carried.
- Damage done to other people's property (such as docks, lighthouses and buoys) by the vessel colliding with them.

Collision liability

Contrast this with the liability insurance available under the hull policy – this is for colliding with **another ship** only.

- Removing the wreck after an incident.
- Damage caused to the vessel if they have hired (or chartered) the vessel from the owner.

  This type of liability insurance is generally known as Protection and Indemnity Insurance (usually shortened to P&I) insurance. There is more discussion in relation to these types of insurance in study text *LM2*.

Vessel-owners or operators are not the only parties involved in the maritime business who can incur liabilities to others. Other parties which should also consider purchasing insurance to protect themselves from the financial consequences of incurring liabilities to others are:

- **Port authorities**
  - Damage to vessels caused by the harbour not free of obstructions or the docks not secure.
  - Damage to vessels caused by shore cranes.
  - Damage caused by port authority tug boats (used for towing larger ships in the confines of a port).
  - Liability to cargo owners if they release the cargo from their care to the wrong parties.
  - Liability to neighbouring properties for pollution arising from liquids or dust.
  - Liability to vessels for engine damage if the port authority provided substandard bunkers (ships fuel is known as bunkers).
- **Shipbuilders or ship repairers**
  - Liability for not repairing or building a vessel properly.
  - Liability for damage to other vessels following an accident such as a fire or explosion in the shipyard.
  - Liability for injuries to personnel or visitors.
- **Marina owners**
  - Liability for pleasure vessels damaged whilst in the marina.
  - Liability for individuals injured whilst on marina property.
  - Liability for any injury caused by food or drink if the marina has a bar or catering facilities.
  - Liability for providing fuel or stores which are not of the correct standard.

Particularly for those land-based businesses such as marinas and shipyards, the liability for their employees will normally be covered by a standard non-marine employers' liability policy and there is nothing particularly maritime about the nature of the coverage, other than the insurers need to know the nature of the business.

Question 3.3

A yacht marina provides fuel to both those who moor there and to visiting vessels. If damage is caused to the vessels by the fuel and the marina is sued, which marine insurance policy should respond?

a. Liability ☐
b. Hull ☐
c. Property ☐
d. Personal accident ☐

A6 Political risks insurance (PRI)

The rapid globalisation of financial markets has opened significant avenues for multinational banks, commodities traders and many other companies transacting business overseas. Notwithstanding the massive opportunities gained by operating in emerging markets across the globe, there are, nonetheless, inherent and highly unpredictable political perils which can have a significant impact on a given corporation's assets, investments and trades in second and third-world countries.

PRI offers one of the means for investors and businesses to mitigate and manage the risks arising from the (in)actions of, or the restrictions imposed by, hostile or unconstitutional governmental actions and in doing so helps foster a more stable environment for trade and investments into emerging markets and thus can help to open new and to bolster existing channels of finance.

The portfolio of subclasses of political risks insurance offered within the market is extremely varied. It includes asset risks, such as CEND (confiscation, expropriation, nationalisation and deprivation), CCP (central counterparty), and contract frustration risks, such as non-payment and non-delivery by public and private obligors, exchange transfer, non-honouring of documentary letters of credit and wrong calling of bonds. In addition, the PRI market has successfully catered for war on land and political violence alongside the other perils aforementioned.

It offers the trade finance banks a realistic alternative to syndicating exposure to their direct competitors. It also offers an alternative for exporters to using state-funded Export Credit Schemes, which can sometimes be very slow and/or bureaucratic. Export Credit Schemes also have very strict acceptance principles, often relating to the amount of the goods produced emanating from the host country. Private market insurance, of course, does not have any of these restrictions. Political Risks insurance also offers a high level of capacity in key markets, such as Africa, which it would now be impossible to effectively find elsewhere. The presence of Political Risks Insurance can also help a customer to obtain backing for their project from trade-finance banks on more slightly preferential terms.

Useful website

Use this link to access a political risk map:

www.aon.com/risk-services/crisis-management/political-risks.jsp

A7 Offshore energy insurance

In this section, we will look at that part of the energy market that developed from the marine market, in relation to the location and extraction of oil and gas from under the seabed.

The offshore energy insurance market is also known as the 'upstream' area of the business, as contrasted with the onshore energy market which is generally termed 'downstream'. In the middle is the part not unsurprisingly called 'midstream', which also tends to be insured in the onshore market.

Construction insurance is covered in section B1C

Be aware

The term upstream is used to define any part of the industry involved with the extraction of oil and gas and therefore you can have upstream risks on land – much oil/gas drilling is done onshore as well as offshore.

The offshore energy business can be divided into three distinct phases of operation (in relation to the client's business):

Three phases of offshore energy business are exploration, construction and operational

Exploration phase	This is where the oil and gas is searched for using mobile drilling rigs which can be moved from location to location as required. The risks in this phase are both physical in nature to both the rig and the surrounding area (weather-related for example) and the liabilities to people, other property and for pollution should there be a blowout (an uncontrolled flow of oil or gas to the surface).
Construction phase	Once a viable source of oil or gas is located, a more permanent rig has to be constructed to remain on-site. This insurance will cover the whole construction period, often involving multiple locations around the world, the bringing together of all the parts and the on-site fitting. As with the exploration phase, this type of insurance covers both physical damage and liability risks.
Operational phase	Once a permanent rig has been constructed the rig moves into the 'business as usual' phase – and together with the physical damage and liability risks already seen in the exploration and construction phase, additional risks such as war and terrorism have to be considered.

Windstorm risks

One risk that all aspects of the offshore energy insurance market face is windstorm. The 2005 and 2008 hurricanes that went through the Gulf of Mexico oilfields caused unprecedented damage. The key problem was mobility or rather lack of mobility of the items insured.

Activity

Find out if your company was involved in any of the energy losses following the 2005 and 2008 hurricanes. Are any of the claim files still open?

B Non-marine insurance

In this section, we will look at the classes of business written in the London Market that can be grouped together as non-marine. We will not be re-visiting those items (such as fine art) that can be written in both the marine and non-marine markets.

B1 Property insurance (including construction and onshore energy)

In this section, we will explore those areas of insurance which are loosely grouped as property, but in reality, cover several different areas.

B1A Property insurance

Property insurance is physical damage insurance for buildings

As the name suggests, this is physical damage insurance for buildings. As with ships, buildings come in various shapes and sizes such as:

- office buildings;
- industrial buildings (including factories and warehouses);
- public buildings (including theatres and libraries);
- retail units of all sizes;
- agricultural buildings; and
- domestic buildings, i.e. houses.

Buildings vary dramatically in their construction and use; these factors impact on an insurer's consideration of the risk. Whatever their variations, there are several common threads in terms of the insurance that is available from the property market. As with marine cargo, there are some additional types of insurance that also appear in this market which do not obviously 'fit' there.

The basic type of property insurance for industrial buildings can also cover machinery, fixtures and fittings within any building – as well as the raw materials before they go into the manufacturing process together with the finished product before shipment.

Claims under property policies are examined further in study text LM2

In a property policy, the method by which the insured can be indemnified includes the option for reinstatement, which is not found in marine policies generally. Reinstatement means to re-build the property that has been damaged; the key here is to ensure that the sum insured is adequate to cover the costs of any reinstatement that might be required, taking into account that it might take some time (and that inflation may push material and labour costs up during that period). Claims under property policies are examined further in study text *LM2*.

There are various other types of insurance that fall within the general definition of property but should be reviewed separately, as follows:

Stock insurance
This is a physical damage insurance covering stock at the insured's premises. Regular declarations of stock levels must be made to the insurer so that in the event of a claim there is no danger of underinsurance.

Theft insurance
Deals with theft involving forcible entry to the property, but generally does not cover any claims where forcible entry is not apparent. This is to avoid any claims for losses arising from collusion involving someone working for the insured.

Theft insurance deals with theft involving forcible entry to property

Glass insurance
As the name suggests this insurance covers specifically the glass elements of a building. It also deals with aspects such as boarding up properties for security purposes after an incident and the replacement of specific items such as inbuilt alarms and lettering on the glass.

Goods in transit insurance
This insurance was covered in section A3H, under 'marine' and will not be reviewed again here. It is, however, important to appreciate that this can be a non-marine risk as often as it is a marine risk.

B1B Pecuniary insurances

These insurances are covering monetary loss rather than physical loss or damage and insurance can be purchased for losses arising from a wide range of internal and external perils.

Money insurance applies to the risks of money and valuable documents such as tickets and vouchers which are the responsibility of the insured anywhere in the world. As with theft insurance, money insurance does not respond if there is any suggestion of an 'inside job'. Additionally, there will be requirements for vehicles to remain attended at all times.

> **Money insurance**
> This insurance is much the same as 'cash in transit' insurance written in the marine market – see section A3G.

Fidelity guarantee insurance responds to fraudulent acts committed during the policy period. (Note that fidelity means faith or trust.)

One type of activity that it responds to is an employee in a position of responsibility diverting funds into their own account. The insured can decide whether to buy a policy that covers all their employees, just certain named ones or use named positions rather than named personnel. Unusually, these policies can be triggered by the discovery of the fraudulent activity some time after it was actually undertaken which means that a policy could be notified of a claim some time after expiry (also known as the 'discovery period').

Business interruption is also a type of pecuniary insurance but is reviewed separately in section B2.

B1C Construction insurance

The construction of a building, as with a vessel or an oil rig, is a lengthy process. It generally involves several different parties, ranging from those responsible for preparing the foundations, through to the specialist companies (such as crane operators) involved in different areas of the build and fitting of the building.

On a typical building site, there is a main contractor who engages specialist sub-contractors to perform specific tasks and each party could and should obtain their own insurance. However, it also makes sense for central policies to be obtained which have a number of the parties involved as insureds. This serves to prevent gaps in coverage should anything go wrong. These policies commence their cover at the start of the work and terminate once the project (or a discrete element of it) is handed over.

If required, maintenance periods (which cover the period immediately after handover of the project (or part of the project) can be built into the policy cover usually for twelve months. This allows for the 'snagging element' of any construction to be dealt with under the main construction policies, whereby faults that appear in the first few months are identified and repaired.

If required, maintenance periods can be built into the policy cover usually for twelve months

Contractors all risks (**CAR**) and **Erection all risks** (**EAR**) policies are a combination of physical damage and liability cover. CAR policies are usually purchased by the main contractor on behalf of other sub-contractors and EAR policies are purchased by the contractor responsible for putting up or installing machinery, or steel structures of any type.

Two types of liability cover available

The types of liability that must be covered under these policies are: damage to third party property; and bodily injury to third parties.

Activity

Look around where your office is based and consider the risks within any constructions projects you can see.

B1D Onshore energy insurance

As we saw in section A7, midstream and onshore/downstream energy insurance covers those elements of the oil and gas industry that come after it has been successfully located and recovered from the depths of the earth.

Midstream insurance covers pipelines and downstream covers the refining and petrochemical processing elements of the business. It is important to appreciate, however, that the onshore energy business does not solely incorporate elements related to oil and gas, but can also include mining, power generation risks (including nuclear power stations) as well as renewable energy sources such as hydroelectric power, wind farms, solar energy and biofuel plants.

In terms of the coverage available, it is broadly similar to a construction or property risk, taking into account the specialist nature of the property insured and the issues relating to the construction of such facilities. Additionally, it is prudent to obtain liability insurances (discussed in more detail in section B3).

B2 Business interruption insurance

As we saw in section A2, if a vessel is damaged and cannot be used to generate income, then the insured could lose money. The same is true for property-related risks and business interruption (BI) insurance serves to replace lost income after a waiting period (usually expressed in days as per the marine 'loss of earnings' policy).

Basic BI insurance requires physical loss or damage to the insured property which triggers the shutdown and consequent loss of income

Basic BI insurance requires physical loss or damage to the insured property which triggers the shutdown and consequent loss of income.

It is always possible, however, that the shutdown of a factory or other facility may have been caused by a problem located outside the actual property itself. Two examples of this situation are as follows:

- A supplier of raw materials fails to provide supplies to a factory. Although some of the raw material has been stockpiled, once it has been used up the factory has to stop work.
- A power supplier's premises are damaged which cuts off power supplies to the insured's factory.

In these cases, a policy which requires 'physical damage to own property' in order to trigger the BI section would be of little or no use. A separate policy or extension of coverage known as a 'contingent business interruption' has been developed which requires evidence of a link between damage to an external party and the insured shutdown, but not damage to owned property.

Question 3.4

A metal smelter maintains a reserve of raw material which will cover five days' production. Their suppliers call them to advise that no more will be delivered for at least ten days and there are no other suppliers. The factory manager knows they will have to shut the factory down in five days' time and does not know when they will be able to restart. Which insurers should they notify?

a. Property ☐
b. Business interruption ☐
c. Liability ☐
d. Contingent business interruption ☐

B2A Advanced loss of profits (ALOP)/delay in start-up (DSU) insurance

In all types of major construction projects, time is of the essence. As a result, there are penalty clauses in the various contracts and sub-contracts which cause significant financial pain if invoked. They are invoked if the project overruns either an interim timeline or a final delivery date – for a number of reasons (generally, of course, those within the control of the contractor). However, alongside the contractual penalties imposed on contractors, there are the real risks of loss of profit and increased debt servicing costs should the project not be completed on time.

In all types of major construction projects, time is of the essence

Loss of profit and debt servicing cost provisions and the costs of working overtime (known as increased costs of working) can be insured and are found both in marine and non-marine insurances.

- **Marine** – this type of provision will be found in a type of cargo insurance known as 'project cargo'. In these policies, the items being shipped tend to be large pieces of equipment destined for power plants and similar projects. Should they not arrive on time the knock-on effect to the project will be a considerable delay. Additionally, the items concerned tend not to be off-the-shelf items so replacing lost or damaged items will take time.

  The policy will be in two parts, the first, a standard cargo policy and the second: 'delay in start up' (DSU) which covers the financial impact of the project not starting up on time.
- **Non-marine** – this type of policy is often purchased as an additional cover by those companies buying CAR/EAR cover. It works in the same way as the marine-related policy described above, in that it is triggered by delays incurred because of physical damage occurring to assets which delays the build process.

B3 Non-marine liabilities (also known as casualty)

As we saw in section A5, as well as purchasing physical damage insurance for loss or damage to owned property, it is prudent to consider obtaining insurance to cover any legal liabilities which might be incurred during the operation of a business.

In chapter 1 we reviewed the types of insurance that are compulsory in the UK, and although it may not have appeared obvious at the time, they relate to liability insurances rather than physical damage insurances.

Reinforce

If you cannot recall the types of insurance that are compulsory in the UK, re-visit chapter 1, section J.

There are various types of liability insurance available in the London Market and we will consider a few of them here:

- **Employers' liability** – this is a compulsory form of insurance in the UK and its US equivalent, known as 'workers' compensation', is also compulsory. This insurance covers the employer should an employee become injured during their employment and make a claim against their employer. There is a specialist marine version of this policy known as 'maritime employers' liability' and cover for ship's crew can be provided by the P & I insurers.
- **Public liability** – this insurance covers any party who is liable for loss or damage caused to members of the public visiting their premises, or for any loss or damage caused by an employee to a client or member of the public. A good example might be an underwriter visiting a broker's office and tripping over something.
- Examples of typical insureds are:
  - shops (if you trip and fall on a wet floor that has not been cleaned up);
  - restaurants (if you get food poisoning);
  - nightclubs;
  - riding schools – this is a compulsory form of insurance in the UK.

  Any insured could obtain a public liability policy to cover their activities, however, the coverage provided in common with other policies may also be subject to some exclusions.

Examples of public liability insureds are shops, restaurants, nightclubs, local councils and riding schools

- **Professional liability** – this insurance covers professionals such as lawyers, doctors, accountants, stockbrokers against the risk of a claim being made against them for incorrect advice or negligent activity. In relation to this type of risk, the claim would be made against them for anything which amounted to a breach of their professional duty, with the claimant having suffered perhaps financial loss or even physical damage of some type.

Chapter 3

Medical malpractice insurance

In relation to the medical profession this is also known as medical malpractice insurance. In this area, the types of damage likely to be suffered are those caused by a badly performed operation or difficult birth causing injury or death to either mother or child.

Certain types of professional negligence are compulsory in the UK (for example for lawyers) in order to maintain their practicing licences.

Motor insurance is not generally written in the London Market

- **Motor liability** – motor insurance for standard individual motor risks is not generally written in the London Market – rather by different divisions of the insurance companies or by service companies linked to the syndicates. Basic motor liability insurance is also a compulsory insurance in the UK and covers only liability to a third party for loss or damage to them or to their property.
- **General liability** – this insurance can cover a number of different areas of liability and can be purchased either as a freestanding policy or in addition to a physical damage or construction type policy. Rather than covering a specific type of liability such as public or professional, this policy seeks to provide rather more general cover that will respond as long as the insured has a legal liability.

Advertising injury

The types of liability that these policies will pick up include advertising injury (which includes not being hit on the head with a hoarding) which is a claim that you have slandered someone else by writing something about them which was untrue.

- **Products liability** – as the name suggests this insurance relates to a product causing physical damage to something or injury to someone (personal or bodily injury). The insurance is not, however, only available to the manufacturer of a product but to any party in the manufacture, sales, supply and distribution chain.

In reality, when a party is injured or has their property damaged by a product, they may choose to claim against a number of different parties in the supply chain, including the retailer and the manufacturer and therefore there may be a number of different policies interested in the same claim.

Activity

Open your store cupboard at home and choose a packaged food product. Think about how many different organisations might have been involved from the raw materials through to your buying it and bringing it home.

Write some notes here about the various parties and where they fit in the chain.

Please note that in relation to US business the term 'casualty business' is often used to mean non-marine liability insurance of all types.

B4 Bloodstock/livestock insurance

This is not pet insurance – which is not generally written directly in the London Market, but insurance on animals that are used for business. Bloodstock means horses, generally racehorses and other types of competition horses such as show-jumpers. Livestock can cover many other animals such as alpacas, cows, sheep, llamas, camels and even fish farms.

The main risk is the death or illness of the animal

The main risk is the death or illness of the animal. This basic cover can be extended to cover infertility of a stallion or a mare when put to stud following their retirement and any prospective foals that are due to be born.

B5 Contingency insurance

Contingency is the underlying concept of insurance in that it requires a fortuity; however, there is a specific group of insurances known as contingency insurance.

This includes event cancellation, weather-related insurances, prize indemnity, death and disgrace and over-redemption.

Event cancellation	This insurance will generally cover concert or event promoters against the risk of an event having to be cancelled because of performer illness. When considering the risk, the insurer will take into account the health of the performer, the nature of the concert tour or event being insured and the options for re-arranging concerts if required, so as to minimise the losses.
Weather-related insurances	Such as rain washing out Wimbledon, or cricket test matches. These insurances will usually require significant rainfall.
Prize indemnity	This insurance covers against the risk of a golfer sinking a 'hole in one' at a nominated hole at a certain tournament whereby they might win a cash prize or a high-performance car. This insurance is essentially statistical in nature and the underwriter will try to calculate the odds of the incident occurring. As a precaution, there will also be an independent adjudicator on site during the event to ensure no odd behaviour (cheating).
Death and disgrace	This insurance covers organisations which are faced with additional costs to reshoot advertising campaigns either because the famous person who is fronting an advertising campaign is found to be less perfect than previously believed (having committed a form of indiscretion – such as adultery – or crime such as drug-taking) or in fact suddenly dies – perhaps entirely by accident – which is more usually the case with sports personalities.
Over-redemption	This insurance is linked to offers and promotions on items such as crisp packets where members of the public can send coupons off and receive items such as books for their school. The crisp manufacturer is operating the promotion to increase its sales; however, it does not want to find itself in the situation where the promotion is so popular that it costs more money than the increased sales generated.

Here, the insured and insurer work out the likely response rate that is expected given historic information and the insurer generally provides insurance that will be triggered by a response in excess of that which is expected.

Activity

Look at the link below and find out about the concert cancellation claim for The Rolling Stones:

www.musiclawupdates.com/?p=6044

Activity

Look at this website and see how Hoover's brand was damaged by a promotion that went badly wrong.

http://ind.pn/1LzXlBQ

B6 Personal accident insurance

There are a number of different insurances written in the London Market which fall under the general title of 'personal accident' and we will look at some of these in overview here:

- **Personal accident** – as the name suggests, this insurance is triggered by an accident. However, this is not a policy of indemnity as it is not possible to put a price on the loss of a hand, a leg, sight or hearing. Instead, the policy has a schedule of benefits which are paid out should the policy be triggered.

  There are a number of options as to the payouts: weekly or monthly benefits plus the potential for lump sums should the injured person suffer permanent or temporary total disablement.

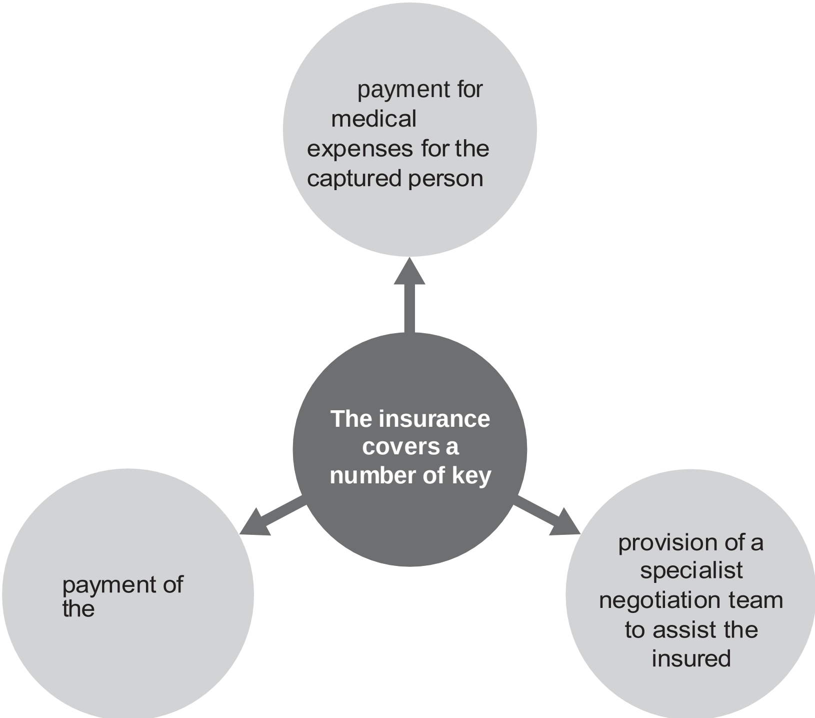
  A lump sum payable on death is another feature that can be built into these policies.

  This type of insurance can be taken out for sports people who run a far higher risk of being unable to continue with their chosen career should they suffer injury. Insurers seek to contain the risk by putting restrictions or outright bans in the policy around activities such as recreational motorbike riding.
- **Personal illness or sickness insurance** – in contrast with the previous insurance this type is triggered by sickness as well as an accident or injury. This insurance is often also known as accident, sickness and unemployment cover (ASU).
- **Death in service** – this insurance is generally purchased by employers to cover the situation where an employee dies whilst in their employment and the employer has to pay (in accordance with the employment contract) 'death in service benefit' to the employee's beneficiary. This generally amounts to a lump sum payment of between two and four times' salary. This type of insurance is not generally written in Lloyd's although there is a term life market which provides life cover for a short policy period of up to a maximum of 25 years.

B7 Kidnap and ransom insurance

Death in service generally amounts to a lump sum payment of between two and four times' salary

Kidnap is the capturing of a person and then demanding payment or a ransom for their release. This is quite a common occurrence in certain parts of the world and companies and individuals will take out this insurance, either for themselves or for key personnel.



One of the main issues with this type of insurance is that its existence should be kept secret by all concerned

One of the main issues with this type of insurance is that its existence should be kept secret by all concerned and even within the insurers and brokers only very few personnel know the actual identities of the insured persons. As you can imagine, making public this type of insurance puts the persons concerned at even greater risk than they would otherwise be – from those keen to make money out of them.

Kidnap and ransom insurance is also written in the marine insurance market as a specialist vehicle for the payment of ransoms demanded by pirates seizing ships and cargoes.

B8 Malicious product tamper/extortion/product recall insurance

Imagine the horror of a person in the head office of a major supermarket chain who receives a phone call or a letter telling them that some food at one of their shops has been tampered with. A number of things will be running through their minds, such as:

- removing the potentially affected items off the shelves as quickly as possible;
- replacing that stock; and
- maintaining brand loyalty should news of the tampering incident leak out.

The actions that are taken after the receipt of the message all cost money, which is where this insurance will assist the insured. In the case of extortion, the person or organisation sending the message demands money in exchange for:

- revealing information about the contamination; and/or
- keeping quiet about the contamination story.

! Extortion is, in fact, another word for blackmail.

If a retailer identifies a safety issue with one of its products (e.g. a supermarket discovers glass in one of its food lines). Warnings have to be sent out to the general public, stock has to be removed and destroyed and the brand image maintained as far as possible. In addition, a regulator might order a recall of products because of a suspected problem. The challenge here is that there might not have been any loss or damage, but the insured is working to maintain their reputation.

Activity

Keep an eye on the newspapers and watch for advertisements recalling any type of product – food and children's toys are the most common. A good example in 2013 was the horsemeat in processed food scandal.

Look carefully at the wording of the advertisements and consider whether your view of the brand is impacted in any way.

B9 Intellectual property insurance

Intellectual property is the technical term for the rights that companies and individuals have to their work or their inventions. Trademarks can also be protected in the same way and authors seek to protect the copyright of their books.

Logos will also be protected and companies will challenge others who they believe are causing them problems by using similar names or logos in their business. The problem occurs when brand names actually become used in English as normal words.

Consider this…

If you are doing your housework, do you decide to 'vacuum' the room or to 'hoover' the room? Hoover is a brand name, however, it has been around for so long, it has become the verb we use for the actual activity – we rarely 'Dyson' or 'Miele' a room, which suggests that those brand names, among others, have not become so much a part of our consciousness.

Inventors patent their inventions legally to protect their rights to use them and more importantly make money from them. Should someone try and interfere with your rights then you can sue them but this costs money.

Intellectual property insurance primarily covers the legal costs of defending an action against your intellectual property, or alternatively if you are alleged to have interfered with someone else's intellectual property rights.

Activity

Look at a novel and find the copyright information near the front. The symbol to look for is ©.

Question 3.5

A charity is holding a black-tie ball to raise funds and one of the activities will be a gaming table where there will be the chance of winning a Ferrari if the correct combination of dice is thrown. The local Ferrari garage will supply the car but they are not willing to donate it. What type of insurance should the charity purchase to cover the risk of someone winning the car?

a. Motor ☐
b. Intellectual property ☐
c. Prize indemnity ☐
d. Liability ☐

C Aviation insurance

In this section, we will look at the different types of risk that can be insured in this part of the market. What we will see is that the basic concepts of physical damage and liability insurances exist in this area, just as they do in marine and non-marine insurances.

C1 Physical damage insurance

There are different types of aircraft and flying objects which present different risks to the insurers, as follows:

- **Private pleasure fixed wing aircraft**. These can vary in size depending on the spending power of the owner and their propulsion will vary from jets to propellers. The basic construction is broadly the same, although the materials vary from the older aircraft to the more modern together with the number of electronics on board. In this way, a private pleasure aircraft has much in common with a yacht.

  The risks that the insurer considers for any aircraft fall into the three categories of taking off, landing and flying. The insurer considers the nature of the construction of the aircraft, the propulsion and the experience of the pilots – as well as the journeys that will be made.

The risks that the insurer considers for any aircraft fall into the three categories of taking off, landing and flying

- **Commercial fixed wing aircraft**. As with private aircraft, commercial aircraft vary hugely in their size, propulsion and amount of electronics on board. The challenge for the insurer, as with any class of insurance, is to remain up-to-date with the modern developments in construction and design so as to consider any changes in the nature of the risk that are presented to the market.
- **Rotary aircraft**. Helicopters can fall into both the private ownership and commercial category and present different risks given the nature of the technology. Perhaps most obviously is the fact that if the engines fail, they do not glide as well as fixed wing aircraft (although they do not necessarily fall directly to earth either). Helicopters are often used in difficult terrain – perhaps to support construction or drilling projects and are therefore worked harder than an equivalent fixed wing aircraft.
- **Gliders**. These look like fixed wing aircraft but have no independent means of propulsion; gliders can suffer the same types of physical damage to the structure as a fixed wing aircraft or a helicopter.
- **Microlights**. These are essentially hang-gliders with the addition of small engines to power them, rather than relying on the prevailing wind; they are used in a popular leisure activity. The wings are made of thin material stretched over a frame and are therefore liable to damage easily on impact and the engine is relatively unprotected to ensure that weight is minimised.
- **Hot air balloons**. The traditional concept of a hot air canopy with a basket underneath has been taken to extremes in recent years with increasingly extraordinary shapes invented (whilst still maintaining the concept of the hot air canopy over a basket and a burner to keep the air hot). The canopy is relatively fragile and should the balloon descend too rapidly, it is the basket and the burners that will impact first and suffer the most damage.

Aviation insurers will not cover wear and tear losses

These types of aircraft/flying machines can be insured for physical damage. Insurers need to be aware of the use of the aircraft and the locations in which they will be operating. Just as with other types of physical damage insurance, aviation insurers will not cover wear and tear losses.

C2 Aviation liabilities

As we have seen already, organisations and individuals can incur legal liabilities should they cause loss or damage to someone else or their property. The coverage given under the standard aviation policies for airlines falls into three main categories of passengers, third parties other than passengers and products-related liabilities.

Passengers	As long as the injury occurred either whilst boarding, disembarking or on the plane. Therefore, if an airline passenger falls over in the airport's duty-free shop, it is likely to be the responsibility of the airport operator – not the airline. Damage to luggage is covered as long as something also happened to the aircraft.
Third parties other than passengers	Covers baggage handlers or other ground staff.
Products-related liabilities	For illness resulting from food provided on the plane, contaminated aviation fuel being supplied, or repairs undertaken with substandard parts.

Employers' liability for injury to aircrew would be covered under a standard employers' liability policy – there is no need for a specialist aviation version.

C3 Loss of licence/loss of use insurance

In the same way as we saw (for marine and non-marine insurances) in sections A2 and B2, if an aircraft is damaged and cannot be used, the owner could lose money. Loss of use insurance provides a replacement income stream, after a waiting period measured in days (with a maximum sum payable per day).

If an aircraft is damaged and cannot be used, the owner could lose money

Additionally, 'loss of licence' insurance is available within the aviation market, which generally deals with an individual who has failed their medical – resulting in the loss of licence to operate in their role as aircrew or air traffic controller. As long as the medical failure was not their fault and they have not lost their licence because of another reason (such as drinking on duty), this insurance provides replacement personal income.

C4 Airport operators' policies

These policies provide insurance protection for the particular risks faced by organisations that manage or operate airports. These policies combine both physical damage and liability insurances and fall generally into three areas of coverage:

Premises liability	Someone falling over in the duty-free shop would be reported here, although it should be noted that if there were no negligence on the part of the insured, there would not necessarily be a claim.
Products liability	If the airport provides fuel for the aircraft.
Hangar-keepers' liability	If the airport provides maintenance or storage services for clients. You do not need to actually have an aircraft hangar!

D Reinsurance

In this section, we will move away from what is known as 'direct insurance', where the contract is between an insurer and a company or an individual. Reinsurance is still a contract of insurance but the entity buying the policy is itself already an insurer and is buying the reinsurance for itself in order to transfer some of the risks it has underwritten through risk transfer from the original or direct insureds.

In this section we will review the nature and uses of reinsurance together with the buyers and sellers of this specific type of insurance. A more detailed review of reinsurance is provided in study text *LM2*.

A more detailed review of reinsurance is provided in study text LM2

D1 What is reinsurance?

As we saw in chapter 1, insurance is a mechanism that operates to transfer risk from an insured to an insurer. Also, in chapter 2, we saw that insurers themselves have an insurable interest in subject-matter because of the financial risks they have taken on by accepting insurances.

Put these two together and we have the answer: insurers who want to transfer some of their own risk to other insurers – known as reinsurers.

It can best be summarised in the form of an equation:

Insurer paying premium to reinsurer to transfer risk	=	reinsurer accepting transfer of risk from insurer along with the premium

There are various ways to arrange this – listed at the end of this section and discussed in detail in study text *LM2*.

Reinsurers can be organisations that also operate as insurers (i.e. they 'write insurance') or they can be organisations that specialise in writing reinsurance (with perhaps a very small portfolio of insurance on the side).

There is no limitation on the length of the reinsurance chain; fundamentally it is a matter of supply and demand – if someone wants to buy reinsurance and there is someone willing to sell the product at the right price, a deal can be done.

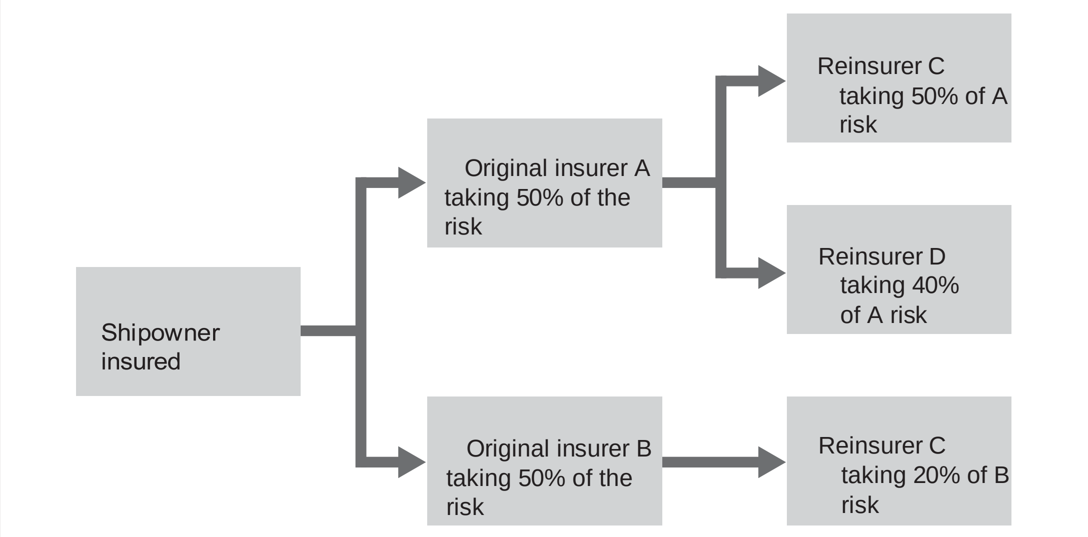
Example 3.2

This chain is the most straightforward set of relationships showing one insurer or reinsurer at each point in the chain.

1. A shipowner wishes to purchase insurance – they are called the **original insured**.
2. One insurer agrees to write the whole risk – it will be known as the **insurer or original insurer**.
3. The insurer decides to purchase some reinsurance for this risk – and approaches another insurer – it will be known as the **reinsurer**.
4. The reinsurer can purchase some more reinsurance for itself if it chooses from another **reinsurer**.
5. That reinsurer can also buy itself some more reinsurance and this can go on forever as long as someone is there to sell it.

It is also possible to have more than one insurer and/or reinsurer at each point in the chain. The London Market is a subscription market which means that more than one insurer generally shares each risk. We will see more about this in chapter 9. Diagrammatically, the chain would look more like Figure 3.1:

Figure 3.1: More complex chain



As can be seen from Figure 3.1, Reinsurer C has sold reinsurance to insurers A and B. This is perfectly acceptable and quite normal in the London Market; however, it is very important for it to monitor what it has done. Although these examples and diagrams only show one set of reinsurers, the chain of reinsurers can have many links between the original risk and the final reinsurer in the chain who will have no information at all concerning the original risk or risks insured.

This concept of risk and exposure monitoring is reviewed further in study text LM2

This concept of risk and exposure monitoring is reviewed further in study text *LM2*.

There are many different ways of buying reinsurance, in terms of the breadth of cover. This can be described as reinsurance covering:

- a single risk – often used for unusual risks that the insurer is writing;
- a certain class of business – for example, all business written as property, or marine cargo;
- the insurer's whole portfolio of business; or
- catastrophe losses.

D2 Purpose of reinsurance

Reinsurance has not been made compulsory (certainly in the UK), although the purchase of appropriate reinsurance is viewed by the regulators as good business practice.

The purchase of reinsurance remains a strictly business decision for an insurer

Therefore, the purchase of reinsurance remains a strictly business decision for an insurer.

Clearly, when considering the premium for an original risk, the insurer must factor in the cost of any reinsurance it is going to require. There is little or no point giving away the entire inwards premium on a risk to reinsurers.

Let's return to the equation that we looked at in chapter 1, section F:

Premium ? claims + operating costs

This could be written as:

Inwards premium ? claims + reinsurance costs + operating costs

Remember that this equation is saying that premium has to be greater than or equal to claims plus reinsurance costs plus operating costs.

The purchase of reinsurance does not remove the insurer's obligation to pay valid claims under the original insurance policy. Therefore, should the reinsurer used become insolvent, this is a business risk that the insurer itself faces and should not impact on the original insured.

The purchase of reinsurance does not remove the insurer's obligation to pay valid claims under the original insurance policy

D2A Benefits of purchasing reinsurance

- **Increasing capacity**. Individual underwriters will have authority limits which will restrict the share of any one risk that they can accept. The underwriter is the person (or group of people) employed by the insurer to review and accept risks on behalf of the insurer.

  By purchasing reinsurance, the underwriter can increase the individual share of any one risk that they can accept as a direct insurer which will have the knock-on effect of helping increase their status and market share overall.

  From an organisational perspective, insurers will have a combined financial capacity that they can accept during the course of the year, which will be monitored by the regulators.

Financial capacity

If a glass can only take a pint of water, then you can never squeeze more than a pint into that glass, you need a bigger glass. Financial capacity is also a function of size but based on the permission obtained from regulators as to how much business can be squeezed into the insurer, based on premium income. If you want to squeeze more than a pint of business into the insurer, you have to ask the regulator for a bigger glass (better known as more capacity).

Just as we saw for individual underwriters, prudent purchasing of reinsurance will allow the insurer to accept more direct risks, having reduced its (direct) gross exposure through reinsurance.

Prudent purchasing of reinsurance will allow the insurer to accept more direct risks

This also has an obvious benefit to the customers and the intermediaries as it allows insurers to take a greater share of risks in the first instance thus making the placing and potentially, the claims process far quicker, without impacting the insurer's net financial position.

Gross and net

Referring to the pint glass above, the gross capacity of an insurer is the amount of business that is written (or water poured into the glass). By buying reinsurance, you are taking some water out of the main glass and putting it into another glass, thus making more room to pour water into the main glass.

The net position is the one after you have emptied some water out of the main glass to make room for more to be poured in.

- **Smoothing peaks and troughs**. Insurers are keen to ensure that their trading results each year show gradual trends, rather than high peaks or deep troughs. Importantly, investors prefer to see stability in insurance companies.

Reinsurance helps by spreading the cost of very large losses over a period of time. In the case of a large loss that affects an insurer and its reinsurer (where there is an arrangement covering more than one risk), the temptation for the reinsurer might be to increase its prices for that insurer immediately – to try to recoup its costs attached to the large loss. Doing so would immediately affect the cost base of the insurer; instead the reinsurer usually takes a longer-term view and applies price increases where adverse loss trends emerge. This spreads the cost to the insurer over several years having the effect of smoothing out the highs and lows.

When purchasing reinsurance, the insurer should consider the likely peaks and troughs in the coming year and balance that against the amount of money it is prepared to spend on reinsurance. It is all too easy to get the calculation wrong and have inadequate reinsurance in any one year.

Reinsurance helps by spreading the cost of very large losses over a period of time

Allowing the insurer to diversify into new classes of business	If a new insurer is setting up or an established one moving into a new class of business then the regulators (in the UK, the PRA) see the purchase of reinsurance to protect the fledgling business as a sign of good business practice.
Protecting the portfolio (class of business)	It is possible to arrange reinsurance on a single known risk. When insurers do this, it is known as **facultative reinsurance**. However, it is equally important for insurers to protect the pool of accumulated premium funds from the effects of very large losses or a series of losses arising from a single cause. Therefore, it is possible to purchase reinsurance that will cover a group of losses arising from one cause, albeit that they might present claims through different original risks written by the insurer. This is generally known as treaty reinsurance.

?

Question 3.6

Which of the following is **not** a reason for purchasing reinsurance?

a. The original insurer is not permitted to write the business ☐

b. Risk transfer ☐

c. To even out peaks and troughs in an account ☐

d. To increase capacity ☐

D2B Benefits of writing/selling reinsurance

Accessing other geographical areas	Insurers are often limited in the geographical areas from which they can source business – we will examine this topic further in chapter 7. Often the restrictions are placed on insurers writing direct business, so by writing reinsurance it is possible to widen the geographical scope of the business.
Accessing other classes of business	Writing reinsurance is a good way of ‘testing the water’ in relation to new classes of business with a limited exposure in terms of capital expenditure. Other ways of accessing new classes of business would be to employ a team of underwriters with all the attendant issues of subsequently ‘un-employing’ them again should the exercise not prove profitable. Generally, reinsurance is an annual contract which does not have to be renewed and therefore if a particular contract proves to be unprofitable then it does not get renewed.

Activity

Have a look at the Munich Re website – try to find out whether they write any direct insurance.

www.munichre.com/en/homepage/index.html

D3 Sellers and buyers of reinsurance

D3A Sellers of reinsurance

Reinsurers are often limited liability companies with substantial amounts of paid-up capital

Reinsurers are often limited liability companies with substantial amounts of paid-up capital, sometimes in excess of £100m, due to the high risk attached to the business.

Paid-up capital is the amount of money received into the company from the shareholders – so a company with a large amount of paid-up capital will generally have a large number of shareholders. Companies can increase their paid-up capital by issuing more shares.

Many smaller reinsurance companies operate in specialist classes of business

However, some reinsurers have far less capital, meeting only the minimum statutory requirements. Many smaller reinsurance companies operate in specialist classes of business. The main types of reinsurer are:

- specialist companies that do not write any direct insurance at all;
- Lloyd’s syndicates; and
- insurers who also write reinsurance as well as direct business.

Reinsurers accept risks either directly from the insurer (also known as the reinsured) or through a reinsurance broker. They provide reinsurance for:

- insurance companies;
- captive insurers; and
- other reinsurers.

Reinsurers are included in this list, as they too seek to transfer some of their risks to other reinsurers. As already discussed earlier in the chapter, the buying of reinsurance is very much based on supply and demand.

Reinsurance is an international business and insurers usually spread their risks over a number of reinsurance companies at home and abroad. Many Lloyd's syndicates also buy and sell reinsurance to companies who are members of the International Underwriting Association (see chapter 6).

The main reinsurance markets – other than London – are Bermuda, the US and Europe. The Bermudan market is a major competitor to London. Many insurers who have offices in London are in fact headquartered in Bermuda for regulatory and taxation reasons.

The main reinsurance market other than London is Bermuda

Activity

Review the Lloyd's Annual Report which can be downloaded from: www.lloyds.com/lloyds/investor-relations and compare the amounts of reinsurance business and direct business coming into Lloyd's as shown in the opening pages of the report.

Also compare with the London company market via the IUA statistics reports: http://bit.ly/2x17nR6

D3B Buyers of reinsurance

Some of the main buyers of reinsurance are insurers and reinsurers; however, there are some additional categories of buyer, namely captive insurers and mutuals.

Captive insurers

A captive insurance company is one set up as part of a larger commercial organisation and it takes risks only from its parent company or group. The main advantage of a captive is that the parent company or group is not impacted by general premium increases across the market. The main disadvantage is that in the event of a loss the only source of funds available to deal with claims are those within the captive. Obviously, the parent company should fund the captive properly and ring-fence funds to deal with claims, but another way of protecting the captive's financial position is to purchase reinsurance in exactly the same way as any other commercial insurer would.

A captive insurance company takes risks only from its parent company or group

Mutuals

Mutuals involve like-minded organisations grouping together and forming an insurance pool amongst themselves, often run by professional managers on behalf of the member firms which vary between lawyers, architects and marine liability insurers. Mutuals purchase reinsurance using exactly the same sort of considerations (in terms of extent and type) as a commercial insurer.

Activity

1. Research the BP captive 'Jupiter' and see if you can find out whether it purchases reinsurance.

2. Review the website of marine liability insurers 'International Group' and examine the reinsurance that it purchases. https://www.igpandi.org/reinsurance

Chapter 3

D4 Reinsurance terminology

The different types of reinsurance are covered in detail in study text LM2

In this section, we are going to cover some reinsurance-specific terminology. The different types of reinsurance are covered in detail in study text *LM2*.

To cede	The act of sharing the risk with reinsurers.
Cedant	Another word for the original insurer who is passing the risk to reinsurers.
Cession	The share of the risk passed to reinsurers.
Collecting note	The document used to present the claim to reinsurers.
Facultative reinsurance	Reinsurance purchased for an individual risk, generally because it would not fit within any other part of the reinsurance already available. Will only respond to claims arising out of that one risk.
Non-proportional reinsurance	Reinsurance where the premium and claims do not have a direct correlation. The premium will be set more in line with a direct insurance, and the claims will be dealt with on a purely financial basis, rather than on a shared basis. Excess of loss and stop loss are examples of this type. Claims will be paid out in excess of a pre-agreed amount.
Proportional reinsurance	Reinsurance where the premium and claims are shared between insurer and reinsurer in pre-agreed proportions, such as 30%. In the simplest form of contract there will be no financial limitations, the reference will only be made to proportions but in more complex contracts there will be limits expressed in financial terms relating to the size of the risks that can be shared with the reinsurers. Quota share and surplus treaty reinsurance are examples of this type.
Retrocedant	A reinsurer obtaining reinsurance for itself.
Retrocession	A cession where the entity ceding is already a reinsurer.
Retrocessionaire	A reinsurer accepting reinsurance from an entity that is itself a reinsurer.
Treaty reinsurance	Reinsurance that can be purchased to cover a wider portfolio of risks, either a class of business or even an insurer's whole book of business.

?

Question 3.7

What is the term used for transferring a risk to a reinsurer?

a. Cede ☐
b. Transfer ☐
c. Claim ☐
d. Payment ☐

Key points

The main ideas covered by this chapter can be summarised as follows:

Marine

- Insures vessels, cargoes and liabilities as well as offshore energy risks.
- Also insures construction risks.
- Some risks cross over between marine and non-marine areas such as fine art and specie.

Non-marine

- Covers buildings and liabilities associated with property.
- Also covers construction of all types of buildings.
- Liabilities also covered here including professional liabilities – all compulsory insurances are within non-marine area.
- Onshore energy including power generation and alternative energy risks.
- Personal accident policies are benefit policies not policies of indemnity.

Aviation

- Covers physical damage to aircraft as well as liabilities.
- Airport operators take out separate policies.

Reinsurance

- Reinsurance is the same as insurance – but the buyer is already itself an insurer.
- Reinsurance is sold by dedicated reinsurers, Lloyd's syndicates and insurance companies that deal in both insurance and reinsurance.
- Reinsurance is purchased by insurers, reinsurers, mutuals and captives.
- Reinsurance has several benefits for buyers such as access to new markets, increasing capacity, assistance with starting up new business lines.
- Reinsurance has benefits for the sellers as well, such as access to new geographical areas and classes of business.
- Reinsurance has some specific terminology which should be used to avoid confusion.

Question answers

3.1 The correct answer is b.

3.2 The correct answer is c.

3.3 The correct answer is a.

3.4 The correct answer is d.

3.5 The correct answer is c.

3.6 The correct answer is a.

3.7 The correct answer is a.

Self-test questions

1.	What type of insurance covers the construction of ships?
2.	If you own a gallery and want to insure paintings and sculptures, which type of insurance do you need?
3.	What types of precautions do 'cash in transit' insurers expect their insured to take?
4.	What type of risks does political risk insurance cover?
5.	If a business wants to insure against employees stealing money from it, which type of insurance is suitable?
6.	What does business interruption insurance cover? How are the limits and excesses expressed?
7.	List four examples of organisations that would be wise to purchase public liability insurance.
8.	How is personal accident different to other types of insurance?
9.	In aviation liability insurance, what are the three groups of likely liabilities?
10.	List three different ways of buying reinsurance.

You will find the answers at the back of the book

4

The insurance cycle

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Learning objectives

After studying this chapter, you should be able to:

- explain supply and demand; and
- outline and explain the insurance cycle.

Introduction

In this chapter, we will start by examining the concepts of supply and demand and their application to the insurance marketplace, followed by a review of the insurance cycle.

Key terms

This chapter features explanations of the following terms:

Equilibrium	Influence of major events	Insurance cycle	Legal and political influences
Necessities versus luxuries	Pricing	Price elasticity of demand	Subscription market
Supply and demand			

A Supply and demand

In this section, we will explore the concept of supply and demand and how it works in any type of marketplace. This provides a good introduction to the specific effects that the principles of supply and demand have on the insurance market both in London and overseas.

A1 What is meant by supply and demand?

Supply and demand is the relationship between the price of the commodity and the quantity traded

The principle of supply and demand is relevant for any seller or supplier; it is the relationship between the price of the commodity and the quantity traded. To a certain extent, it also relies on a mixture of luck, a review of historical information and – in some cases – the weather.

The ideal balance is that the quantity supplied equals the quantity demanded; known as equilibrium.

Example 4.1

A shopkeeper has 500 ice creams available on a particular day for £1 each and they sell the last one at the end of the day as they are closing the shop. Here, the supply of ice creams exactly matches the demand. Neither side of the equation is unbalanced in any way and everyone is happy. The shopkeeper is happy because they have sold all their ice cream and the buyers are happy because everyone who wants an ice cream gets one, at a price they are prepared to pay.

Activity

Imagine it is the hottest day of the year and you have just gone into a shop for some ice cream. How would you feel if they had sold out?

Write some notes about your attitude to the shop and whether it would impact on your decision to shop there again.

Now put yourself in the position of the shopkeeper in that situation.

Write some notes about how you, as the shopkeeper, would feel if you did not have enough stock of ice cream to satisfy all your customers on the hottest day of the year.

What if you, as the shopkeeper, had stocked up in advance with lots of ice creams for the school holidays and in fact, it rained for the whole summer. You have hardly sold any ice creams, you are running out of freezer space and the expiry date on the ice creams is approaching.

Imagine how you, as the shopkeeper, would feel in this scenario. What problems are you facing?

Staying with food products, let us consider how a shop might manage the challenges of supply and demand. What tools can it use to ensure that it balances the equation and over what aspects do they have little or no control?

A2 Tools to manage supply and demand

These include historic and current information, competitive pricing and exclusivity of the product.

Historic information	Past trading patterns, for example, weather reports which give a clue to the weather patterns throughout the year, or previous patterns of demand for a particular product.
Current information	For example sporting fixtures. By knowing when major sporting fixtures are held, shops can ensure that they have adequate stocks of barbeque items and other essentials.
Competitive pricing	The extent to which this tool can be used is entirely dependent on the size of the organisation and the extent to which it can balance out aggressive pricing in one area with realistic pricing in another (so as not to end up putting itself out of business).
Exclusivity of product	If a shop is the only supplier in the area, this provides an element of control; as shoppers will generally only travel a certain distance to buy basic products.

People are prepared to make a special long-distance trip to places such as an exclusive department store which only exists in London, but will not be prepared to make a long journey to obtain a pint of milk that they can get nearer home. The difference between these suppliers is as follows:

- The London store is a **high order service** and has a large sphere of influence; people will travel a long way for that one-off special purchase.
- The local milk supplier is a **low order service** and has a low sphere of influence. People will not travel far to purchase a pint of milk.

Reinforce

If we apply these concepts to communities we can see a similar model appearing:

Village – serves the local community only.

Town – serves a wider area including a number of villages.

City – serves a much bigger area including a number of towns and villages.

Activity

Think about the following products:

- a loaf of bread;
- weekly food shop; and
- new sofa.

How far away from where you are typically based would you be prepared to travel to obtain this product? (Ignore for this exercise the impact of online shopping.)

A3 Over what do shops have little or no control?

Shops have little or no control over:

Competition in the local area	this can be partially controlled by the competitive pricing mentioned above but cannot be completely overcome.
Data used for forecasting or decision-making being inaccurate	particularly data such as weather forecasting or changes in fashion.

A4 Pricing impact on supply and demand

Can shops charge whatever price they want for products? What is the effect on demand to a change in price? If the price of an ice cream was to double overnight, it is expected that demand will fall, as people will go without an ice cream or buy a cold drink/ice lolly instead.

Compare this to an increase in the price of petrol. If the price of petrol goes up by 25%, what effect will this have on demand? Compare this also to a commodity such as car insurance. If at renewal, the premium quoted has gone up 25% on last year, what effect does it have on your decision to purchase?

Consider this…

If your favourite bar of chocolate cost £1 yesterday and today it costs £2, but most other chocolate bars are £1, would you still buy your favourite one, if there was no other obvious difference?

A4A Necessities versus luxuries

Products can be divided broadly into necessities and luxuries which has an impact on their demand and whether they are purchased at all. Insurance would not generally be called a luxury as there are many situations where the buying of insurance is either obligatory or required as a term of doing business (i.e. as a prerequisite for obtaining a loan to purchase a building or a ship).

Reinforce

Can you remember which types of insurance are compulsory in the UK?

If an item is a necessity, then a change in price will potentially have less impact on demand than if the item is a luxury. However, there is a basic relationship between price and demand that we will review briefly.

A4B Price elasticity of demand

Put simply, if the price of a product or service goes up the demand for it goes down. The 'elasticity' element is working out how much the demand goes down as the price goes up.

Reinforce

If the price of an ice cream goes up 10%, what will be the effect on demand?

Knowing the degree of elasticity is important; if you know that the demand for ice cream will drop by **more** than 10% if you raise the price by 10%, then it is not worth the risk of raising the price. Conversely, if you know that demand will drop by only 3% if you raise the price by 10%, then it tells you that the market can bear the price rise and good business tells you to do it.

Activity

Speak to six of your colleagues, friends or family who have car insurance. For each of them:

1. Find out what type of insurance they have, comprehensive, third party, fire and theft or third-party only. (Remember that only third party insurance is compulsory, anything else is a choice.)
2. If they have comprehensive cover, ask them: If the price had been too high for comprehensive, would they have bought a lesser insurance or would they always pay for comprehensive, whatever the price?

A5 Achieving equilibrium

If demand is present for a certain product, there are three types of status that can be used to describe the marketplace:

- There is just enough supply to meet demand (equilibrium).
- There is not enough supply to meet demand (under-supply).
- There is more than enough supply to meet demand (over-supply).

B Supply and demand in the insurance marketplace

In this section, we will apply the concepts learned so far in this chapter specifically to an insurance market.

B1 Why new insurers join the market

New insurers join the insurance marketplace if they think that there is greater demand than there is current supply; i.e. that the insurance marketplace is not in equilibrium and there is under-supply. The new insurers think they can make a profit by increasing supply.

Example 4.2

Imagine a marketplace with one trader selling ice creams. They are the sole provider in the area and have many customers. Queues often form and by mid-afternoon, they have sold out. Other business people see their success and set up market stalls in the same area selling the same ice cream at the same price. Some of the original trader's customers go to the new traders although there is no obvious price-cutting taking place.

The key to this part of the pattern or cycle is that 'new players' are coming into the market with the expectation of making a profit as they can see that the player currently in the market is already doing so.

Subscription market

The London Market has many insurers working within it and a number of them can take shares of the same risk depending on their appetite and capacity. This type of market is known as a subscription market.

By entering the market, the increased investment or capacity in that area of the market increases the supply of goods (whether ice creams or insurance coverage) and this has an impact on price.

In a subscription marketplace, there is no price control; the insurance brokers are of course trying to obtain the best product for their customers (a balance between price and terms and conditions). If insurers start to compete for business and try to maintain their market share (because there is more supply than there is demand) then one of the easiest areas in which to compete is price.

In a subscription marketplace, there is no price control

If aggressive pricing takes place (where insurers are prepared to accept business at a price that is very low in relation to the perceived risk being presented) then pressure is placed on the rest of the market to accept risks at a lower price to obtain or maintain a share of business.

Example 4.3

Let us look at the next stage of the story of the marketplace for ice cream traders:

- More market traders come in and are all selling the same vanilla ice cream in the marketplace.
- The demand is then split equally between them. However, at the end of the day, one of them has ice cream left over so reduces their price to get rid of it.
- As the other market traders see what they are doing, a couple of them start to get aggressive in their pricing to try to get a larger share of the demand. This means that unless the others can come up with other ways to attract customers, they too will have to reduce their prices to remain competitive.
- Then due to completely unforeseeable circumstances, the vanilla crop fails and supply stops overnight. The commodity price goes up ten-fold and there is an insufficient supply of vanilla to meet the demands of ice cream manufacturers.
- Total ice cream supply is reduced, whilst demand remains unchanged. This shortage of supply forces prices up. At the same time due to higher than anticipated production costs, manufacturers and sellers leave the market because they believe that they will not be able to sell at the price required to cover their new increased production/ purchase costs. The ice cream market is in turmoil and totally out of equilibrium.

Question 4.1

If a particular class of business is profitable, more insurers will decide to write that class of business. What impact, if any, is this most likely to have on rates?

a. No impact ☐
b. Rates will decrease ☐
c. Rates will increase ☐
d. No pattern will emerge ☐

B2 Why insurers leave the market

The main reason that insurers leave the market is that they suffer large losses, which leads to lower profits (or no profits at all). Whilst the losses will not be caused entirely by lowering their premiums too far, the lack of premium income generated will, of course, make any losses more painful in the long run. Certain classes of business are more volatile than others, in that losses – when they are suffered – tend to be large. A good example of this would be the offshore energy insurance market. After the 2005 hurricanes hit the Gulf of Mexico, a significant number of insurers (both in London and elsewhere in the world) swiftly exited the offshore energy insurance market – and many others chose to restrict heavily the coverage they provided.

The main reason that insurers leave the market is that they suffer large losses

Example 4.4

Let us continue the story of the ice cream market traders. Remember that prices were forced low when the other traders came in, then the price of vanilla became high thus impacting on the price at which the traders will be buying in the stocks of ice cream. Some of the traders cannot afford to remain in the market as they have to sell ice creams at a price lower than they obtain them from their suppliers – thus making a loss.

Activity

Find out whether the organisation that you work for had any involvement with the 2005 hurricanes (Katrina, Rita or Wilma). If your organisation wrote or was a broker to energy business then, find out whether they still do so, or whether they have now left the market for this business.

Find out if your organisation has written aviation war business and whether it has suffered losses in recent years. Is it still writing the business?

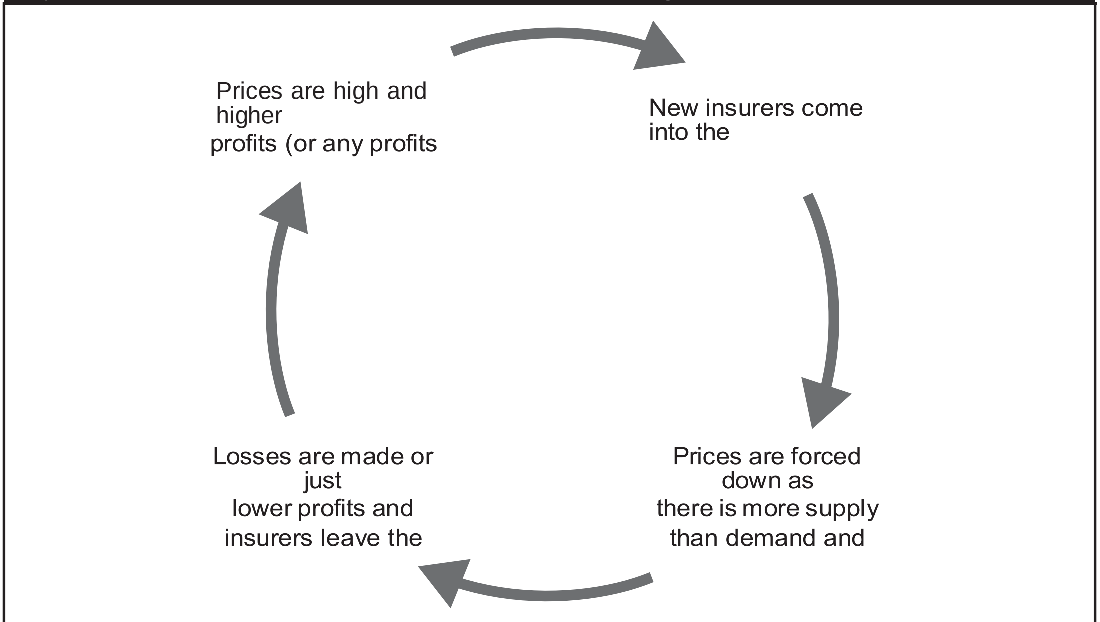
B3 Impact on rates of new market entrants and leavers

In the shopkeeper examples in section A1, we saw that an over-supply has the potential impact of pushing down prices. When an over-supply is rebalanced, it is possible that it will swing too far the other way and the supply becomes too low to satisfy demand. This means that the sellers can control the price more readily and prices will go up.

The increase in price will lead generally to profits and those outside the market will think it is now a good time to join (either again or for the first time).

Figure 4.1 presents this cycle in relation to insurance:

Figure 4.1: New entrants to the insurance market: impact on rates



Question 4.2

After a major hurricane many insurers decide to stop writing windstorm business. What is the likely impact on rates, if any, of this decision?

a. No change to rates ☐

b. Rates will decrease ☐

c. Rates will increase ☐

d. Rates will stabilise ☐

It is quite common to hear the words hard and soft applied to the market at any point in time or even to different sectors of the market. A hard market is one where there is an excess of demand over supply and one where insurers have more ability to influence rates due to less capacity. Conversely, a soft market is one where there is an excess of supply over demand and it is far more difficult for insurers to push prices up.

C Reasons why the insurance cycle might vary

In this section, we will look briefly at the sort of external influences that might impact on the insurance cycle, causing it to go round either more quickly or slowly than expected – or perhaps not operate at all as expected.

C1 Legal and political influences

- The law might be changed to make more or fewer types of insurance compulsory.

Consider this…
If the law was changed to make comprehensive motor insurance compulsory, do you think that lots of insurers, not currently writing motor insurance, would join the market? What impact do you think that would have on prices if they are aggressive in their pricing to get market share quickly?

- The law might change to extend liabilities for which insureds can be found responsible – even during the currency of a policy. These liabilities may not have even been contemplated when the risk was written. The international nature of the market means that it is not just changes in English law that impacts on insurers' exposure as the insureds that are covered by London Market insurers are based and work worldwide.
- The ability of the market to write business in certain parts of the world might be increased. For example, the work done to extend the ability of Lloyd's syndicates to write business coming out of India by obtaining a licence from the Indian authorities or by opening offices in Latin America.

Activity
Access these news bulletins to read more about Lloyd's expansions:

www.lloyds.com/news-and-insight/press-centre/press-releases/2017/04/lloyds-india-branch-officially-opens

www.lloyds.com/news-and-insight/news-and-features/lloyds-news/2015/10/lloyds-and-china-taiping

Read this information about expansion into Latin America: www.lloyds.com/lloyds/offices/americas/brazil

As a result of the Brexit vote, Lloyd's in conjunction with other insurance organisations decided to establish a platform within the EU setting up an insurance company in Brussels. The EU platform is expected to write business from 1 January 2019.

Useful website
Read more about Lloyd's establishing an EU platform in Brussels here:

www.lloyds.com/news-and-insight/press-centre/press-releases/2017/03/lloyds-to-open-eu-insurance-company

Activity
Find out what impact Brexit has had on your organisation – will you be opening new offices perhaps?

C2 Impact of major events

The events of 9/11, as well as the 2005 hurricanes in the Gulf of Mexico, were some of the largest losses to hit the London insurance market. The capacity of Lloyd's to write business has not decreased year on year, although some market participants have chosen to leave certain sectors (such as the offshore energy market post-2005 or recently, the aviation war market as previously stated).

The events of 9/11, as well as the 2005 hurricanes in the Gulf of Mexico, were some of the largest losses to hit the London insurance market

The general impact of these events is to shorten the insurance cycle as they accelerate the reduction in individual players (i.e. supply is less) in certain areas of the market, thus permitting significant increases in premiums.

Weather-related events have an impact on insurers. As well as the hurricanes just mentioned, these include events such as large-scale flooding, as seen in recent years both in the UK and in Europe. Such events call into question historic data on which insurers base their planning – such as the likelihood of catastrophic weather more than once in 100 years. The uncertainty that this produces can drive insurers away from certain classes of business in a way that will also impact the cycle.

Weather-related events have an impact on insurers

Question 4.3

What is the most likely impact on the market if a catastrophic loss is suffered?

a. Lower capacity and higher premiums ☐
b. Lower capacity and stable premiums ☐
c. Higher capacity and stable premiums ☐
d. Higher capacity and lower premiums ☐

Key points

The main ideas covered by this chapter can be summarised as follows:

Supply and demand

- The relationship between supply and demand is a balance that applies equally to insurance as to any other product.
- Balance can be impacted by the necessity or otherwise to buy insurance.
- Price has an impact on demand but an increase in price may not produce an equal change in the demand.

Supply and demand in the insurance marketplace

- The insurance market grows and shrinks in a cycle based on insurers seeing profits being made and wanting to join the market and share in those profits.
- Aggressive price reductions will lead to losses and insurers will leave the market again, thus allowing those remaining to generally increase the price again.

Reasons why the insurance cycle might vary

- Large losses due to weather and natural catastrophes can shorten the insurance cycle.
- Changes in the law and major events have the potential to change the cycle.

Question answers

4.1 The correct answer is b.

4.2 The correct answer is c.

4.3 The correct answer is a.

Self-test questions

1.	Define supply and demand.
2.	Identify some of the tools that can be used to manage supply and demand.
3.	Which types of insurance would be described as a necessity in the UK?
4.	If the market is said to be in equilibrium what is the relationship between supply and demand?
5.	If there is more demand for insurance than insurers in the market what will be the likely result?
6.	After a major loss what is likely to happen to the supply of insurance?
7.	How might a change in the law impact on supply and demand?

You will find the answers at the back of the book

5

Structure of the London Market

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Learning objectives

After studying this chapter, you should be able to:

- describe the main participants in the London Market;
- explain the role of the London Market Associations;
- explain the role of the London Market; and
- explain the process flow in the London Market.

Introduction

The London Market is a distinct, separate part of the UK insurance and reinsurance sector

The London Market is a distinct, separate part of the UK insurance and reinsurance sector. The main providers in this market are:

- insurance and reinsurance companies;
- Lloyd's syndicates (who will also operate outside London through service companies); and
- Protection and Indemnity Clubs (dealing with aspects of marine liability insurance).

Much of the business is conducted internationally, including significant insurance and reinsurance arrangements.

The London Market is the place where many sizeable or complex industrial risks from all over the world are placed. This market, and perhaps the Lloyd's Market in particular, has been a focus for placing very unusual risks and is arguably unique in the world in this respect.

The gross written premium of the Lloyd's market in 2016 was £29.9bn

To give an indication of its size, the gross written premium of the Lloyd's market in 2016 was £29.9bn (source: *Lloyd's Annual Report* 2016).

Key terms

This chapter features explanations of the following terms:

Association of British Insurers (ABI)	British Insurance Brokers' Association (BIBA)	Brokers	Captive insurers
Contract certainty	Council of Lloyd's	Equitas	External member of Council
Institute of Insurance Brokers (IIB)	International aspects of the London Market	International Underwriting Association of London (IUA)	Limited liability company
Lloyd's of London	Lloyd's Franchise Board	Lloyd's Market Association (LMA)	London and International Insurance Brokers' Association (LIIBA)
London Market Regional Committee (LMRC)	Managing agent	Members' agent	Mutual companies
Mutual indemnity associations	Names	Nominated member of Council	Open years management
Placing a risk	Presenting a claim	Reinsurance to Close (RITC)	Society of Members
Syndicates	Working member of Council		

A Lloyd's

In this first section, we will review the Lloyd's Market.

A1 Lloyd's Market structure and features

The first and most important thing to appreciate is that Lloyd's is not an insurer. Instead it is a marketplace. It is also a world-renowned insurance brand, without ever actually providing any insurance itself.

Useful website

See www.lloyds.com/lloyds/investor-relations for the latest Lloyd's Annual Report containing a graphical representation of the sources of capital.

Lloyd's is a Society of Members; and the Corporation of Lloyd's provides the infrastructure for the marketplace together with a responsibility for international liaison. This will be discussed in more detail in chapter 7.

Several Acts of Parliament stretching from 1872 to 1982 (known as the Lloyd's Acts) define the management structure and rules under which Lloyd's operates.

Under the **Lloyd's Act 1982**, the **Council of Lloyd's** was created and is responsible for the management and supervision of the Market. Lloyd's is a dual regulated institution, with both the Society of Lloyd's and Lloyd's managing agents being regulated by both FCA and PRA, whereas Lloyd's brokers and members' agents are solely regulated by the FCA. More about these regulators will be explained in chapter 6.

The Council normally has six working, six external and six nominated members. The working and external members are elected by Lloyd's members. The Chairman and Deputy Chairmen are elected annually by the Council from among its members. All members are approved by the FCA.

The Council normally has six working, six external and six nominated members

Definitions

A **working member** is one who is actively working in the Lloyd's Market either for a broker or for a managing agent, or did so immediately before retirement. These members have to be members of the Society of Lloyd's, i.e. provide capital for the market.

An **external member** is one who is a member of the Society of Lloyd's (i.e. a provider of capital) but does not fulfil the criteria for a working member.

A **nominated member** is not a member of the Society and a capital provider but comes from outside the market. The nearest equivalent would be the non-executive directors of a company who are not involved with the day-to-day operation of the business.

The Council can discharge some of its functions directly by making decisions and issuing resolutions, requirements, rules and byelaws. The byelaws can be described as market laws which organisations working within the Market such as the managing agents (see section A1B) must comply. Only Council can make byelaws, even though it devolves authority to other bodies and committees within Lloyd's.

Only Council can make byelaws

Currently, there are 38 byelaws in force but they are wide ranging and cover subjects as diverse as underwriting and accounting.

Other decisions are delegated to the Lloyd's Franchise Board and associated committees.

The **Franchise Board** sets the market strategy and is responsible for risk management and profitability targets across the Market. It lays down guidelines for all managing agents and operates a business planning and monitoring process to safeguard high standards of underwriting and risk management, thereby improving sustainable profitability and enhancing the financial strength of the Market.

The Franchise Board first came into existence in 2003 and handles matters delegated to it from Council. Council has additionally delegated some decision-making directly to the Franchise Board.

Activity

Go to www.lloyds.com and review the operational management structure of Lloyd's. Consider the way in which any of the elements impact on the organisation you work for.

Question 5.1

What is the name of the entity responsible for the management and supervision of the Lloyd's Market?

a. The Council of Lloyd's ☐
b. The Franchise Board ☐
c. The Corporation of Lloyd's ☐
d. The Financial Conduct Authority ☐

See chapter 6, section D for more about Council and the Franchise Board.

A1A Syndicates

Syndicates are the groups of private individuals or corporate investors who carry the risks (i.e. they provide the financial backing). Both types of investor (individual or corporate) are known as underwriting members or Names.

Syndicates are the groups of private individuals or corporate investors who carry the risks

In the 1990s there were over 400 syndicates; however, at the end of 2016, there were just 99.

This reduction in number of syndicates does not mean that the Market has substantially decreased in size since the 1990s; in fact, the reverse has occurred. However, the individual organisations in the Market are now much more substantial in size than they used to be. The size referred to is not their employee head count but their capacity to accept risks.

Syndicates have an unusual status under English law as they have no separate legal existence and are merely a sum of their parts (the members), unlike a limited company which exists as a separate legal entity distinct from its shareholders.

Shareholders are the investors in a company, but they are protected to a certain extent in that the company exists in law separate from them as individuals and hence the liabilities of the company are not necessarily transferred to the shareholders.

Reinforce

Looking at it another way – think of a sports team. They play matches each week and they will always be known by the team name, but the individual players might vary from match to match.

Syndicates are often described as Annual Ventures since they exist for one year only

Syndicates are often described as Annual Ventures since they exist for one year only and, therefore, should be properly identified not only by their name or number but also by the relevant year (known as a 'year of account'). A syndicate has a unique name and number (known as its pseudonym) and this remains the same irrespective of the year of account. An example of a pseudonym is HIS/33 which stands for Hiscox, Syndicate 33.

As the syndicates exist only for one year of account, the membership of the syndicate needs to be renewed for each new year of account. As we will see later the membership of the syndicate may stay the same year on year; however, the distinction between the individual years of account must still be made. As the syndicate is just an amalgamation of the members, it requires another entity to perform the day-to-day operational functions of an insurer. This entity is called the managing agent.

Chapter 5

Question 5.2

For how long does a syndicate exist to accept risks?

a. Three years ☐
b. Eighteen months ☐
c. Unlimited life ☐
d. One year ☐

A1B Managing agents

Each syndicate employs a **managing agent** and it is that entity which appoints the underwriters who may accept risks on behalf of the syndicate. Managing agents are companies specifically established to manage the underwriting of one or more syndicates.

Syndicates and managing agents

There were (by the end of 2016) 57 managing agents and they are often known by the same name as the syndicate or syndicates that they manage (which can lead to confusion). Using the example above, Hiscox, Syndicate 33 is managed by Hiscox Syndicates Limited.

A managing agent is an authorised person

A managing agent is an authorised person, regulated by the PRA for prudential requirements and by the FCA for conduct of business issues.

A1C Capital and members/Names

The vast majority of the capital is provided by corporate Names rather than individuals

Capital is the term used for the investment put into the Market by the investors known as members or Names. In today's Market, the vast majority of the capital is provided by corporate Names rather than individuals, although individual members do still exist.

In order to invest in the Market, prospective members (of either type) must be able to show adequate means in a form acceptable to Lloyd's. In practice, this means that Lloyd's needs to be satisfied that the prospective member should be able to pay any claims made against them.

Up until 1994, all members of Lloyd's were private individuals who had unlimited liability, which is as it sounds, personal liability with no upper limit. In the late 1980s, the Lloyd's Market received a number of large claims relating to natural catastrophes such as Hurricane Hugo, some large physical losses such as the Piper Alpha rig in the North Sea and a substantial value of claims arising from pollution, asbestos and health hazard problems originating mainly in the USA. The sheer financial magnitude of these losses hitting the Market meant that many members were faced with very large requests for funds from Lloyd's which, because the members had unlimited liability, could not be capped.

Consider this…

Having unlimited liability to someone really means that they can come and ask you for money and keep on asking for money even when you say that you do not have any more. It means that you will have to sell your possessions to raise more money until you have paid your debts.

One way to avoid debts is to make yourself bankrupt but this is a legal process and will involve handing over cheque books and credit cards to the court, and your bank accounts will all be frozen at least at the start of the process.

Think how you would feel in this position.

To appreciate why the pollution, asbestos and health hazard problems were an issue, you need to understand how the annual life of a syndicate works in practice.

- Each syndicate lasts for a year and will accept risks during that year and will be liable for claims arising from those risks.
- The syndicate will, in fact, keep its books open for another 24 months after the end of the year – not only to let premium finish coming in, but also to allow claims to be notified and hopefully resolved, relating to those risks.
- At the end of the third year, the syndicate wants to close its books and work out if it has made a profit or a loss. But what if claims are still notified in the future, or have been notified but have not yet been resolved?
- A possible solution to this problem is to **reinsure** the outstanding liabilities – but with which organisation? The answer to this question is usually 'reinsure them with the syndicate's next year of account'. Therefore, a syndicate's 2010 account would reinsure its liabilities into the 2011 account.
- This is called '**Reinsurance to Close**' (RITC) and Lloyd's syndicates have performed this exercise for many years.

Open years

If an agreement cannot be reached to reinsure the liabilities of any syndicate year of account, then that year is left open until more clarity can be obtained on outstanding liabilities. Once clarity is obtained then further attempts can be made to agree a RITC.

Open years management is covered in more detail in study text *LM2: London Market insurance principles and practices*.

Example 5.1

Syndicate A writes risks between 1 January 2010 and 31 December 2010.

Syndicate A leaves its books open during 2011 and 2012 for that 2010 year of account.

In early 2013 it reviews the books relating to the 2010 year of account and calculates a RITC premium to pay to the 2011 account so that the 2010 year accounts can be finalised and closed – enabling either a profit or loss to be declared.

- Therefore, when claims were presented against policies written by syndicates in the 1950s and 1960s, the successor syndicates in existence in the 1980s had to deal with them. The main problem was that as the claims (such as those relating to asbestos) had never been anticipated, no reinsurance premium had ever been rolled forward year-on-year to deal with the claims – leaving the modern syndicates facing huge claims that were completely unexpected.

Recall from earlier in this section we discussed that prior to 1994 the Market investors or Names were individual investors. Those individuals were faced with enormous claims and with unlimited liability, many of them were bankrupted as a result.

The result of that period in the history of Lloyd's was a need to rebuild the Market and this was done through a process called **Reconstruction and Renewal** (**R& R**) whereby a dedicated reinsurance vehicle called Equitas was created. The entirety of the Lloyd's Market for the 1992 year of account and prior was reinsured into Equitas and the 'new' Lloyd's Market started with a 'clean sheet' for the 1993 year of account.

Reinforce

Remember the concept of RITC where years of account were reinsured into the next year. Some syndicates open years which could not be closed before R & R were also made the responsibility of Equitas.

Following this R & R, corporate capital or investors were brought into the Market and the amount of corporate capital in the Market is now high. No new individual Names with unlimited liability are permitted to join Lloyd's, however, if a Name was writing on an unlimited basis prior to 1 January 2001 they can continue to do so. Individual Names with limited liability are still welcome although, in reality, many of the old unlimited liability Names have converted to limited liability Names.

Useful website

See www.lloyds.com/lloyds/investor-relations for the latest Lloyd's Annual Report which contains a graphical representation of the marketplace.

By allocating their capital support to each syndicate every year, the members govern the amount of business that each syndicate can underwrite each year: the **syndicate capacity**.

Some corporate members will only ever support one syndicate

Some corporate members will only ever support one syndicate, primarily because they only exist to provide capital for that syndicate. Other corporate and individual Names can decide whether to focus on one syndicate or to spread their investment. They are advised as to their investment in the Market by **members' agents**.

The total capacity of any given year is the aggregate capacity of the syndicates for that year. Lloyd's capacity has shown reasonably steady increases since 1999.

Reinforce

Can you recall the pint glass analogy from chapter 3, section D2A? – refer back to it to refresh on the concept of capacity.

Question 5.3

What is the name used for the investors in the Lloyd's Market who are also commercial organisations in their own right?

a. Unlimited Names ☐

b. Corporate capital ☐

c. Scottish partnerships ☐

d. Individual Names ☐

A1D Members' agents

The first role that a members' agent performs is to advise their client on the advantages and disadvantages of investing in the Lloyd's Market. The member can spread their investment across several different syndicates, not necessarily all managed by the same managing agency. Additionally, their choice of syndicates should reflect their attitude to risk.

It is a function of the managing agent to decide how to run the syndicate

It is important to realise that some syndicates do not have individual members and some have capacity that is almost completely provided by individual members. A function of the managing agent to decide how to run the syndicate including sourcing capacity. Good relations between managing agents and members' agents are very important in attracting new investment into a syndicate.

If the client (member) is quite 'risk averse' then investing in a syndicate that writes motor business might historically have given modest, but steady returns (although not today with the sharp increase in motor claims values!). Having the opposite attitude to risk would open up the possibility of investing in syndicates writing other classes of business which are more volatile, such as offshore energy. Whilst this route provides prospects for large profits, it also provides the potential for large losses.

The members' agent also acts as the communication channel between the member and the various managing agencies running the syndicates in which the member has invested, receiving the regular reports on the profit (or not) made by the syndicate. Every year, the members' agent advises the member as to any changes in the spread of investments for the following year of account.

Be aware that the terms investment and investor in this text are used in a generic way.

Question 5.4

If a Lloyd's Name feels that they have been badly advised concerning their participation in a particular syndicate, about whose advice will they complain?

a. The Corporation of Lloyd's ☐
b. The members' agent ☐
c. The managing agent ☐
d. The Council of Lloyd's ☐

B Company Market

Any company wishing to transact insurance in the London Market must be authorised to do so by the PRA. The term for such companies is '**insurance undertakings**'.

Any company wishing to transact insurance in the London Market must be authorised to do so by the PRA

The regulators must be satisfied that the applicant complies with the conditions laid down in UK legislation and European Union directives, where relevant.

A number of differences between the Company Market and the Lloyd's Market will be reviewed here.

B1 Market participants

The Company Market in London is very varied in terms of the origin of the companies working within it. Many large international insurance and reinsurance organisations have branch offices in the London Market, as well as UK based companies, such as Royal Sun Alliance, which might also have a large UK regional presence.

B2 Marketplace

There is no equivalent in the London Company Market for Lloyd's in its role as the provider of a physical marketplace.

B3 Regulation

The PRA regulates insurance companies operating in London for prudential requirements (solvency/levels of capital etc.); the FCA regulates them for conduct of business issues. EU companies are regulated by their own home regulator. There is no additional regulation provided for companies in the same way that managing agents and syndicates are subject to Lloyd's regulation. The trade body for the company market – the International Underwriting Association of London – has no regulatory power.

B4 International liaison

Lloyd's engages in liaison with overseas regulators on behalf of the whole Lloyd's Market but individual companies have to make this contact with the regulators separately.

B5 Structure of the insurer

Non-Lloyd's insurers can take a variety of formats such as limited liability companies, mutual indemnity associations, mutual companies and captive insurers.

Limited liability companies	the most common format and the one used by the household names such as Aviva, AXA, Churchill and Zurich.
Mutual indemnity associations	these are similar to syndicates and managing agents in that they are groups of like-minded customers who pool together to create their own insurance pool and organise professional managers to run the business. A good example of these is the Protection and Indemnity Associations set up to handle marine liability business.
Mutual companies	these are owned by the policyholders and generally serve a specific interest group – the most well-known example is the National Farmers Union – NFU Mutual.
Captive insurers	these are insurance companies who are solely insuring risks from sister companies in the same group – such as Jupiter which as we saw earlier is the captive insurer for BP.

Delegated underwriting is discussed in more detail in study text LM2

There is a unique type of company which obtains its capacity to underwrite not from shareholders but from a Lloyd's syndicate. What this means, in reality, is that the Lloyd's syndicate has authorised a company to underwrite business on its behalf. Delegated underwriting is discussed in more detail in study text *LM2*; however, this type of company, which is generally known as a **service company**, is quite popular so worth mentioning albeit briefly here.

Activity

Search for XL Catlin on the internet. See if you can identify how many different types of insurer exist within that organisation. Look for Lloyd's syndicates and insurance companies.

Then search for QBE and see if they have a different type of insurer within their group based in London.

Finally, if you work for a Lloyd's organisation, ask your colleagues whether you have any service companies within the group.

Chapter 5

B6 Source of capacity

For the limited liability and mutual companies, the shareholders (who are the investors in the company) provide the capital and hence capacity for an insurance company to accept risks and to do business.

In a pure mutual organisation, the only risks are coming from the members of the group who will be charged premium based on the size of the risk brought into the pool.

An individual Lloyd's member has to use the services of a members' agent

The shareholders in an insurance company may or may not take professional advice before purchasing shares in the company; it will be entirely a matter of personal choice. However, an individual Lloyd's member has to use the services of a members' agent.

The shares in an insurance company can be publicly traded (i.e. anyone can purchase them) or can be privately held.

Activity

If you work outside Lloyd's make some enquiries and find out what type of organisation you work for. If you work in a Lloyd's insurer, find out if the managing agent is a limited company.

The various types of companies and their structures are discussed in more detail in study text *LM2*.

Question 5.5

What is the name of an insurer that only accepts risks from 'sister organisations' in the same group?

a. Single insurer ☐
b. Captive insurer ☐
c. Solo insurer ☐
d. Capital insurer ☐

C Brokers

Brokers are professional intermediaries and act as the agent of the re/insured in both the placing and claims process. An intermediary can be defined as a middle-man and can exist in many different areas of business, not just insurance.

The role of the broker is explored further in chapter 8

They must be authorised by the regulator (FCA), but brokers can apply to Lloyd's to obtain a second accreditation as a Lloyd's broker. Non-Lloyd's brokers are not prevented from placing business in the Lloyd's market, however.

Consider this…

If you work for a broker – is it a Lloyd's broker? If so, why do you think your company has obtained that second accreditation?

If you work for an insurer – do you do any work with non-Lloyd's brokers? If not, why not?

D International aspects of the London Market

Many of the organisations working within the London Market either have their roots or links outside the UK. Many US insurers are now operating in the London Market either as a company or via a Lloyd's syndicate as this provides them with the optimum platform to access business from a worldwide client base. The Lloyd's brand provides value over and above their own corporate brand.

Many of the organisations working within the London Market have their roots or links outside the UK

In addition to insurers being international, the business coming into the London Market is also truly international with only a relatively small proportion of business placed in both the Lloyd's and company markets originating in the UK.

Useful website

See www.lloyds.com/lloyds/investor-relations for the latest Lloyd's Annual Report which contains a graphical representation of the geographic spread of business coming into the market in its opening pages.

Look for the company market position in the International Underwriting Association of London (IUA) statistics report: http://bit.ly/2x17nR6

E Market associations

Various market associations represent the interests of particular sectors of the London Market. In this section, we shall be looking at those which represent the syndicates, the companies and the brokers.

E1 Lloyd's Market Association (LMA)

The Lloyd's Market Association (LMA) provides representation, information and technical services to underwriting businesses (i.e. managing agents) in the Lloyd's Market. It was formed by merging into one organisation five separate organisations that were 'class of business-specific'. All managing and members' agents are members of the LMA and are actively involved in its work – participating on its board, committees or business panels.

The stated purpose of the LMA is to identify and resolve issues which are of particular interest to the Lloyd's underwriting community. The LMA works in partnership with the Corporation of Lloyd's and other partner associations, to influence the course of future market initiatives.

Through associate membership (available to trading partners of Lloyd's managing agents and members' agents) the LMA offers an information service to brokers, lawyers and similar businesses connected with Lloyd's.

The LMA offers an information service to brokers, lawyers and similar businesses connected with Lloyd's

As part of its service to members, access is provided to insurance policy wordings. These carry the LMA's copyright.

Activity

Go to the LMA website (www.lmalloyds.com) and research any class of business in which you are interested. See what the LMA groups are doing in relation to market reform, new wordings and education.

Ask your colleagues if they serve on LMA committees.

E2 International Underwriting Association of London (IUA)

The IUA is the world's largest representative organisation for international and wholesale insurance and reinsurance companies

The International Underwriting Association of London (IUA) is the world's largest representative organisation for international and wholesale insurance and reinsurance companies. It exists to protect and strengthen the business environment for its member companies operating in or through London. The IUA is a company limited by guarantee. It has a Chief Executive and is governed by an elected Board, mainly comprising senior market figures.

The IUA came into effect on 1 January 1999 as a result of the merger of the Institute of London Underwriters (ILU) and the London Insurance and Reinsurance Market Association (LIRMA). The ILU represented marine and aviation companies, and LIRMA represented non-marine insurance and reinsurance interests.

An important distinction between the IUA and Lloyd's is that the IUA is solely a representative body and can exercise no control over the activities of its member organisations, whereas Lloyd's does have such ability to control and influence the activities of both insurers and brokers working within that marketplace.

Table 5.1 lists the IUA's priorities, according to its website:

Table 5.1: Priorities of the IUA

Priority	Details
Process efficiency and business attraction to London	The IUA promotes the design and implementation of all aspects of market modernisation, including process reforms and electronic interfaces across the market. This includes working on new processes for placing, claims and accounting and settlement using ACORD standards as the preferred format for data, in conjunction with leading organisation in the market.
Promoting expertise and innovation in underwriting and claims	A full secretariat service is maintained to support the numerous underwriting and claims committees which provide valuable technical input and ideas of best practice to the benefit of the whole membership.
Influencing public policy and compliance	In recognition that insurance and reinsurance regulation is strengthening locally and converging globally, the IUA monitors and responds as necessary to regulatory developments. The consequent compliance activities are linked to the overall public policy work.

Activity

Review the IUA (www.iua.co.uk) website and investigate the different committees that are involved with market activity – refer to the LMA website and identify which areas are covered by joint committees.

If you work for an insurer, ask your colleagues if they serve on IUA committees.

Question 5.6

The IUA exists to represent insurance companies operating in London. Which of these is **not** one of its priorities?

a. Obtaining permission from overseas regulators for companies to write risks ☐

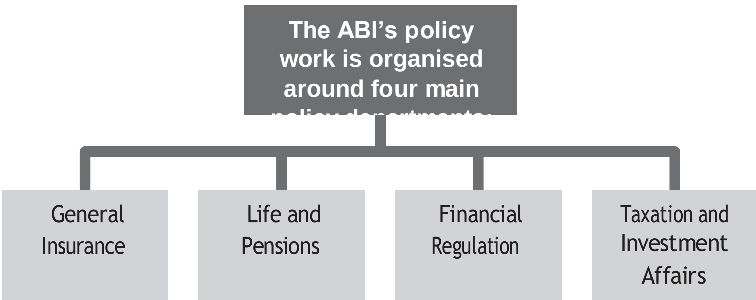
b. Maintaining dialogue with the broking community ☐

c. Supporting underwriting and technical committees ☐

d. Working on enhancing business efficiency ☐

E2A Association of British Insurers (ABI)

This is not a London Market body specifically but some insurance companies with London Market operations will also be members. According to its website, the ABI is the voice of the UK's insurance, investment and long-term savings industry with over 300 members, which together account for around 90% of premiums in the UK domestic market.



In addition, the ABI has an expert Research and Statistics Department and represents the insurance industry to external audiences including the UK Government through its Media and Political Affairs and European and International teams.

E3 Broker-related organisations

There are several different broker-related organisations and for the sake of completeness they are all outlined here.

E3A British Insurance Brokers' Association (BIBA)

BIBA is the major trade association for insurance intermediaries, with a membership of more than 2,000; it is a non-statutory trade body.

BIBA is the major trade association for insurance intermediaries

BIBA draws its members' attention to the need to comply with the fundamental principles that govern the professional conduct of insurance brokers and intermediaries. Its rules emphasise the need for members to conduct business with good faith and to represent the best interests of their customers.

BIBA seeks to maintain and improve the highest standards of business behaviour and to protect and enhance the interests of its members for the benefit of the general public. Its mission statement is: **'To represent and protect the best interests of our insurance broker and intermediary members.'**

According to its website, BIBA strives to achieve this by:

Promoting	the services and contribution that insurance brokers and intermediaries provide with advice, guidance and access to risk management and insurance protection.
Influencing	the relevant decision makers and policy writers that affect our sector.
Maintaining and developing	a stable business environment in which our members operate by keeping them informed of relevant issues, providing a forum for discussion and the exchange of non-competitive information.
Supporting members	both collectively and individually through a series of facilities and support services.

In November 2011 BIBA and the Institute of Insurance brokers joined together to provide one trade association for general insurance brokers. The IIB had been originally founded in 1987 as trade body, professional association and lobbying voice for the brokers and many of its aims were aligned with BIBA which made the merger a logical harmonisation of the bodies.

Activity

Review the BIBA website – www.biba.org.uk/JargonBuster.aspx. See what information it provides the public about the role of the broker and useful dictionary information for consumers.

E3B London Market Regional Committee (LMRC)

The position regarding representation of London Market brokers is slightly complex:

Until the end of 2008, BIBA operated through a virtually autonomous trade body (the **London Market Insurance Brokers' Committee** (**LMBC**)). The LMBC represented the interests of Lloyd's brokers operating in the London and worldwide insurance and reinsurance markets. It was the only representational body at the time.

However, LMBC was disbanded by BIBA at the beginning of 2009. BIBA announced the formation of the **London Market Regional Committee** (**LMRC**) in June 2009 and described it in terms of replacing the old LMBC. As a body, it has been integrated into BIBA's existing regional committee structure.

The intention is to maintain a lobbying role and to represent the sector to the UK regulators, Europe, the UK Government and other stakeholders. It aims to work with other London Market bodies, including LIIBA, on areas of mutual interest and to avoid duplication of work.

E3C London and International Insurance Brokers' Association (LIIBA)

LIIBA is an independent trade body

London and International Insurance Brokers' Association (LIIBA) is an independent trade body, representing the interests of insurance and reinsurance brokers operating in the London and international markets. It effectively took on the role performed by the LMBC from 1 January 2009.

LIIBA's mission is to ensure that London remains where the world wants to do business by continuing the transformation of market processes and maintaining the highest professional standards.

LIIBA's key priorities are:

- Representing members' interests to Government, the regulators, the EU and international bodies to establish a proportionate regulatory framework.
- To modernise the London Market's business processes to be competitive and efficient, delivering an improved client service.
- Supporting members with regarding legislative and technical changes.
- Strengthening relationships with Lloyd's, the LMA and IUA on a wide range of market issues.

F Flow of business in the London Market

The roles of the broker and the underwriter are covered in more detail in chapters 8 and 9

In this section, we will see how business flows through the London Market both as part of the placing and claims process.

Let us start, however, by considering briefly why business comes to the London Market in the first place.

Why not? London is one of many international insurance markets which are freely available to brokers and insureds to access should they so choose. However, for a number of reasons, London is felt to be a leading world insurance market, as follows:

- **Capacity**. Insurers in London have the ability to take on large risks and the subscription nature of the market means that even the largest of risks can be underwritten within the market.

Subscription market

This term means that the risk is generally shared between two or more insurers rather than written 100% by one insurer.

- **Entrepreneurial spirit**. Loosely translated as being prepared to look at new aspects of risk transfer. The insurer works with an insured and their broker to put together a product which suits the client, rather than trying to shoe-horn them into an existing product.
- **Good claims service using knowledgeable personnel**. The claims service is the shop window of any insurer or market and London is no different in this respect.
- **History and experience**. The London Market can channel over 300 years of history and can use its prior knowledge and experience to its advantage when looking at new risks.

Consider this…

One of the London Market's current challenges is that its processes can be quite unwieldy, thus rendering it less efficient than other marketplaces. If those other marketplaces can offer capacity, knowledge and service combined with efficiency, then they might win business.

Use this link to find out more about the London Market Target Operating Model (TOM) project and consider how it might have positive effects: isupporttom.london/

F1 Placing a risk

The broker puts a summary of the risk to be placed and the suggested terms and conditions onto a document called a Market Reform Contract (MRC; still known as a 'slip'). The content and format of this document is governed by clear market rules – in an attempt to obtain both standardisation and clarity as early in the process as possible.

Both Lloyd's and the London Market, in general, have adopted specific procedures designed to ensure that all parties are fully aware of the coverage and terms of the policy before a risk starts to be covered. This was originally developed as part of an initiative known as 'London Market Principles (LMP)' but has been widened to the whole market and is referred to as **contract certainty**.

The reason for the initiative was that there was a practice of 'deal now and detail later' which led to some major issues when the detail had not been dealt with before the arrival of a claim.

Definition of contract certainty

The following definition for contract certainty has been agreed:

Contract certainty is achieved by the complete and final agreement of all terms between the insured and the insurer by the time that they enter into the contract, with contract documentation provided promptly thereafter.

The full wording must be agreed before any insurer formally commits to the contract

To outline, the full wording must be agreed before any insurer formally commits to the contract. The market has decided that appropriate evidence of cover must be issued within 30 days of inception. This can be a formal policy, a copy of the slip or broker-produced evidence of cover such as a Broker Insurance Document (BID).

Note the following points:

- For those transactions that involve a broker, the broker obtains a quotation from an underwriter who is a recognised 'leader' in a particular class of business. The key is finding a leader who will both provide a good quotation for the client but who also enjoys the support and confidence of the rest of the market:
  - this underwriter will indicate the percentage share that they will accept and the terms that will apply;
  - a good broker will seek several quotes for the business from a variety of different leaders if available. Once obtained, the broker should advise their client as to any differences between the quotes and offer guidance as to which is the most appropriate, taking into account the client's requirements; and
  - once the customer has decided which quote to accept, then the broker has, what is known as, a firm order for the business.

The broker can use any market they choose

- Having received the firm order, the Lloyd's broker approaches other underwriters and 'fills' the slip by obtaining signatures for the shares of the risk that they are each willing to accept. The broker can use any market they choose: Lloyd's, London companies or the international market – there is no restriction on them other than to obtain the best deal for their client.
- Once the slip is fully placed (in other words, the percentages accepted by each underwriter total the amount of cover required), the risk must then be submitted centrally for recording on the central market database and the premium paid to the London Market insurers. Historically, this submission was done by depositing documents with a body called **Xchanging Ins-sure Services** (**XIS**) (see below); however, the system has become electronic with the introduction of a system called Accounting and Settlement (A & S). This system is discussed further in chapter 8 and in the *LM2* study text.
- The underwriters usually agree that the broker can deduct a certain percentage of the premium (this deduction is called 'brokerage'). Therefore, the amount of money that is taken from the broker account for transmission to the underwriters will be the **net amount**.

Example 5.2

The underwriter quotes a premium on the slip – called the gross premium – indicating the deduction or brokerage that the broker can take.

The calculation is gross premium minus brokerage = net premium paid to underwriters.

So, if underwriter quotes a gross premium of £1,000 and indicates a brokerage of 20%, the net premium would be £800 (£1,000 – £200 = £800).

- XIS record the risk and premium details on the central market databases for both the Lloyd's and company market underwriters. They facilitate the payment of the premium to both Lloyd's and London company underwriters for the broker.
- A formal policy is not always required, but if one is required the underwriters have the option of producing it themselves or requesting that XIS produce it for them (Lloyd's and companies – the policies will be separate).
- Once the data is recorded and the premium paid, both the broker and the underwriters will get electronic messages from XIS with data about the risk.

?

Question 5.7

If an underwriter quotes a premium of £5,000 and allows brokerage of 25%, how much will the underwriter receive in their bank account when the premium is paid?

a. £5,000 ☐
b. £1,250 ☐
c. £3,750 ☐
d. £4,000 ☐

F2 Presenting a claim

- Once the broker receives a claim notification from their client they need to identify the correct combination of insurers that are required to see and agree the claim (they are called the Agreement parties). The London Market operates under a set of claims-handling agreements (one set for Lloyd's and one for the IUA). This will be discussed in more detail in chapter 8.
- The broker then decides whether they wish to present the claim in paper form or electronically using an Electronic Claims File. If they choose the latter, the broker enters all the data and loads the documents onto the system rather than presenting a paper to the insurer. However, they can still meet face-to-face with the insurers to assist with negotiation and settlement of the claim.
- The broker presents the claim and the data is circulated to all the London Market insurers participating on the risk (even those who are not involved in the claims handling/agreement process) using Xchanging systems.
- If the insurers instruct any experts this is often done through the broker and the broker acts as a conduit to pass on information and reports between the insurers and the experts as well as the insurers and the clients (insureds).
- If there are any settlements to be made, then once the correct combination of underwriters (known as the Agreement parties) have agreed to the presentation, the money again moves electronically from the insurers' bank accounts to the broker (or perhaps directly to a third-party expert such as a lawyer depending on the claim).
- Electronic messages are sent to both insurers and the broker by the Xchanging systems – detailing the transactions, the claims attached and the applicable policy references.
- Once the broker receives any claims monies they forward them to their client to finalise the claim.

Key points

The main ideas covered by this chapter can be summarised as follows:

Lloyd's

- Lloyd's is not an insurer itself, but a marketplace which provides some structure and regulation for the organisations working within it.
- The investors in Lloyd's are called Names or members and they group together into syndicates.
- The Names or members can be individuals or corporate entities.
- Syndicates only exist for a year but their accounts are not finalised for three years.
- Most capital coming into the Lloyd's Market today is corporate in nature rather than individual.
- The syndicates are run by managing agents. One managing agent can run more than one syndicate.
- Members' agents work for Individual Names or members and advise them on their investment in the Market.
- Some insurance companies also have Lloyd's syndicates.

Company Market

- The Company Market comprises insurance companies which have shareholders rather than Names.
- Mutual insurers are groups where the insureds pool together to insure each other using professional managers to run the business.
- Captive insurers accept risks from only one source, usually companies within the same group.
- It is possible for an insurance entity to have both an insurance company and a Lloyd's syndicate within the group.

Brokers

- Brokers are professional intermediaries and act as the agent of the re/insured in both the placing and claims process.
- They must be authorised by the regulators, but brokers can also apply to Lloyd's to be accredited as a Lloyd's broker.

International aspects of the London Market

- The London Market is international both in the sources of capital and in the customer base.

Market associations

- The IUA is the representative body for the Company Market but has no control over the activities of its members.
- The LMA provides representation, information and technical services for the managing and members' agents working in the Lloyd's Market.
- LIIBA is an independent trade body, representing the interests of insurance and reinsurance brokers operating in the London and international markets.
- The market bodies work together on many projects such as wordings.
- There are a number of different broker-related organisations:
  - British Insurance Brokers' Association (BIBA);
  - London Market Regional Committee (LMRC); and
  - London and International Insurance Brokers' Association (LIIBA).

Flow of business in the London Market

- Reasons for coming to the London Market:
  - large capacity;
  - a subscription market where risks are shared between insurers;
  - long history and significant knowledge in the market;
  - London Market insurers are entrepreneurial in nature; and
  - market provides good claims service.
- The broker presents the risk to insurers who if they are prepared to accept it will indicate their agreement on the slip or MRC.
- The broker will receive the premium from the client and pay to insurers less any brokerage that insurers allow the broker to keep.
- Xchanging maintains central market databases for both premiums and claims and moves money for the market through central settlement systems.
- Claims are presented to insurers and, if agreed, funds will usually be paid via the broker.

Question answers

5.1 The correct answer is a.

5.2 The correct answer is d.

5.3 The correct answer is b.

5.4 The correct answer is b.

5.5 The correct answer is b.

5.6 The correct answer is a.

5.7 The correct answer is c.

Self-test questions

1.	What are the terms used for the investors in the Lloyd's Market?
2.	What is the difference between a syndicate and a managing agent?
3.	What is the role of the Council of Lloyd's?
4.	How long does a syndicate exist to accept risks?
5.	Who do Lloyd's Names use as their professional advisers?
6.	What is meant by the term premium income?
7.	Identify some of the different types of company that can operate in the London Market.
8.	For whom is the broker normally working in the London Market?
9.	Which section of the market does the LMA represent?
10.	Which two bodies represent brokers operating in the London Market?

You will find the answers at the back of the book

6

Legal and regulatory environment

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Learning objectives

After studying this chapter, you should be able to:

- describe the aims and approach to regulation of the insurance industry;
- describe the role of the UK and major international regulators;
- explain the governance of the Lloyd's Market;
- explain the role of the Financial Ombudsman Service (FOS) and the Financial Services Compensation Scheme (FSCS); and
- explain how insurers become authorised.

Introduction

In this chapter, we will be looking at some of the basic regulatory structures that exist to control the way in which the insurance market operates in the UK and internationally. This control starts from the approval of new insurers into the business and flows through to the compensation schemes that can apply should an insurer not be able to pay claims. We will also look at the methods by which insurers based in London are permitted to insure risks from other countries, and the regulation that Lloyd's is permitted to perform within its own marketplace.

Key terms

This chapter features explanations of the following terms:

Admitted basis	Capital adequacy	Central Fund	Commercial customer
Conduct risk	Consumer	Council of Lloyd's	Fair treatment of customers
Financial Ombudsman Service (FOS)	Financial Policy Committee (FPC)	Financial Services Compensation Scheme (FSCS)	Franchise Board
Home state financial regulation	Insider trading	Lloyd's Market governance	Money Laundering Reporting Officer (MLRO)
Overseas regulation	Primary rules: byelaws and regulations	Principles for Business (PRIN)	Protected disclosures
Risk-based approach to regulation	Run-off	Secondary rules: requirements	Senior Management Arrangements, Systems and Controls (SYSC)
Surplus lines basis	Threshold Conditions (COND)	Whistle-blowing	Winding-up
Financial Conduct Authority (FCA)	Prudential Regulation Authority (PRA)		

A Overview of the UK regulatory framework

Following the **Financial Services Act 2012**, three financial services regulatory bodies in the UK were created:

Financial Conduct Authority (FCA)

- Separate independent regulator responsible for conduct of business and market issues for **all** firms and prudential regulation of small firms, like insurance brokerages and financial advisory firms.
- Focused on taking action early, before consumer detriment occurs.
- Shift towards thematic reviews and market-wide analysis to identify potential problems in areas such as financial incentives.
- Reviews the full product lifecycle from design to distribution with the power to ban products where necessary.

Prudential Regulation Authority (PRA)

- Sits within the Bank of England and is responsible for the stability and resolvability of systemically important financial institutions such as banks, building societies and insurers.
- Will not seek to prevent all firm failures but will seek to ensure that firms can fail without bringing down the entire financial system.
- Will place emphasis on 'judgment based' approach to supervision focusing on: the external environment, business risk, management and governance, risk management and controls and capital and liquidity.

Financial Policy Committee

- A committee within the Bank of England responsible for horizon scanning for emerging risks to the financial system as a whole and providing strategic direction for the entire regulatory regime.

Reinforce

The PRA is responsible for solvency and stability of those institutions which are felt to be important to the financial services industry as a whole such as banks and insurers.

The FCA takes care of consumer protection and market regulation.

The FPC watches for systemic risks – i.e. those risks that can impact the whole industry.

B Operation of the FCA and PRA

In this section, we will examine the way in which the regulators carry out their supervision, authorisation and regulation of the insurance industry. In line with the exam syllabus, we will be looking only at the high level concepts of regulation here.

B1 Operation of the Prudential Regulation Authority

B1A Objectives of the PRA

Under the Financial Services Act 2012, the PRA has a primary objective to '**promote the safety and soundness of PRA regulated persons**'.

It also has secondary objectives:

- Ensuring that PRA authorised persons behave in a way which avoids adverse effect on the stability of the UK financial system.
- Minimising the adverse effect that the failure of a PRA-authorised person could be expected to have on the stability of the UK financial system.
- Facilitating competition (but note that this is subordinate to the primary objective of promoting the safety and soundness of PRA regulated persons).

Additionally, the PRA has very specific objectives and responsibilities in relation to the insurance industry which are:

- 'Contributing to the securing of an appropriate degree of protection for those who are or may become policyholders'.
- 'An appropriate degree of protection for the reasonable expectations of policyholders as to the distribution of surplus under *with-profits policies*'.

Be aware

A with-profits policy is one with certain characteristics such as:

- A share in certain of the profits or losses of the insurer.
- Certain guarantees, which usually increase over the lifetime of the policy.

For example the payment of a guaranteed amount at maturity or retirement, or on death.

B1B Threshold conditions

Every firm regulated by the PRA, such as insurers, must meet minimum conditions before it will be permitted to carry on regulated activities. These are designed to promote safety and soundness and include:

- A firm's head office, and in particular its mind and management, to be in the United Kingdom.
- A firm's business to be conducted in a prudent manner – and that the firm maintains appropriate financial and non-financial resources.
- The firm itself to be fit and proper and be appropriately staffed.
- The firm and its group to be capable of being effectively supervised.

B1C Risk assessment framework

The PRA's framework involves three elements:

- Potential impact on policyholders.
- The macroeconomic and business risk context in which the firm operates.
- Any mitigating factors including risk management and governance.

The intensity of the supervision will depend on their perceived level of risk but all firms will be facing a baseline level of monitoring which will include:

- Ensuring compliance with prudential standards for capital.
- Liquidity, asset valuation, provisioning and reserving.
- At least an annual review of the risks posed by firms or sectors to the PRA's objectives.
- Assessing a firm's planned recovery actions and how it might exit the market.

The PRA will be constantly assessing any firm's proximity to failure, and will be measuring using the supervisory framework as shown in Table 6.1.

Table 6.1: PRA supervisory framework

Gross risk			Safety and soundness				
1. Potential impact	2. Risk context		3. Operational mitigation		4. Financial mitigation		5. Structural mitigation
Potential impact	External context	Business risks	Risk management and controls	Management and governance	Liquidity	Capital	Resolvability
Source: this table has been reproduced by kind permission of the Prudential Regulation Authority							

For each of the issues identified in the framework such as liquidity and capital, there will be five different stages on what is known as the Proactive Intervention Framework (PIF), each coming closer to failure and if a firm moves into a higher stage in any category, the supervisors within the PRA will be considering their next steps and the management of the firm will be expected to take remedial action to reduce the likelihood of failure.

B2 Operation of the Financial Conduct Authority

B2A Objectives

The Financial Services Act 2012 states that the FCA will have an overarching strategic objective to 'ensure that the relevant markets function well'.

It also has three operational objectives:

- **Consumer protection**: securing an appropriate degree of protection for consumers.
- **Integrity**: protecting and enhancing the integrity of the UK financial system.
- **Competition**: promoting effective competition in the interests of consumers in the markets for:
  - Regulated financial services.
  - Services provided by a recognised investment exchange.

In addition, both the FCA (and the PRA) must have regard to:

- Efficient and economic use of resources.
  - Proportionality.
  - Consumer responsibilities.
  - Transparency.

The FCA has also taken over responsibility for the Financial Ombudsman Scheme and the Financial Services Compensation Scheme.

B2B The FCA's involvement in authorisations and approvals

The FCA focuses on the proposed business model, governance and culture, as well as the systems and controls the firm intends to put in place especially over:

- Product governance.
- End-to-end sales processes.
- Prevention of financial crime.

The FCA works closely with the PRA in considering applications to approve individuals to roles which have a material impact on the conduct of a firm's regulated activities. The FCA will seek to assess that applicants have a good understanding of how to ensure good outcomes through:

- Corporate culture.
- Conduct risk management.
- Product design.

B2C FCA approach to regulation

The FCA intends to be more proactive than the FSA traditionally was and will intervene earlier in a product's life and seek to address the root causes of problems for consumers. Additionally, it is also a body able to review and deal with detailed submissions made by consumer groups (formerly only performed by the Office of Fair Trading).

The FCA's competition objective means that it wants firms to innovate and produce new products but will be watching for those types of innovation that exploit customers as contrasted with those that genuinely meet customers' needs.

B2D FCA approach to supervision

The general principle is that businesses are encouraged to base their business model, culture and day-to-day running on the ethos of treating customers fairly. The FCA's supervisory model originally covered risk categories C1 (large banking and insurance groups with very large number of retail customers) through to C4 (smaller firms including most intermediaries). However, the FCA announced in September 2015 that it was making further changes to its model, including how it classified firms, to support the sector-based approach introduced as part of its 'New Strategy' in 2015. The FCA will continue to look at the way individual firms and people behave, but will also increasingly look at how markets work as a whole, with greater emphasis on sector and market-wide analysis.

Part of the change to the FCA model is a move away from C1 to C4 conduct categories that it has previously used; instead, firms will now be categorised as either 'fixed portfolio' or 'flexible portfolio'.

The FCA approach will vary depending on the risks it has identified in each sector, but may mean that over time, some firms will see changes to how they are supervised. The reclassification meant that around 70 firms moved from 'fixed' to 'flexible' portfolio or from 'flexible' to 'fixed'.

Fixed portfolio firms are a small population of firms (out of the total number regulated by FCA) that, based on factors such as size, market presence and customer footprint, require the highest level of supervisory attention. These firms are allocated a named individual supervisor, and are proactively supervised using a continuous assessment approach.

The majority of firms are classified as flexible portfolio firms. These firms are proactively supervised through a combination of market-based thematic work and programmes of communication, engagement and education activity aligned with the key risks identified for the sector in which the firms operate. These firms use the FCA Customer Contact Centre as their first point of contact with FCA as they are not allocated a named individual supervisor. Contact Centre staff should have the expertise to deal with the majority of issues and queries, and these will be passed onto the appropriate supervision area where necessary.

B2E Risk framework

The FCA has a three pillar approach to risk, and these pillars are:

- Firm systematic framework – which involves asking the question as to whether the interests of the customer are at the heart of the way the business is run.
- Event driven work – flexible supervisory activity driven by issues that are emerging or have recently happened.
- Issues and products – flexible approach which allows the FCA to look at reviews of issues and products as they take place.

B2F What can the FCA do if it finds problems?

The FCA can take a number of steps in response to issues including but not limited to:

- Banning products in the retail sector.
- Withdrawing misleading financial promotions.

B2G To whom will the FCA be answerable?

The FCA is required to report to Government and Parliament annually as well as engage more with consumers directly. It will have to put in place four statutory panels representing the view of consumers, regulated firms, smaller regulated firms and market practitioners.

B3 Practical matters relating to both the FCA and PRA

B3A Handbooks

When the new regulators took over on 1 April 2013 they divided the old FSA Handbook into two new handbooks for the FCA and PRA, with additional material created as required to reflect the regulators' new responsibilities.

B3B Working together

There is a statutory duty for both the FCA and PRA to work together and to co-ordinate their activities, to have a cross membership of their various boards, and to create a memorandum of understanding of how they are interlinked. The PRA also has a power of veto to prevent the FCA doing something, because financial stability can take precedence over consumer protection at times of economic stress.

B4 Principles for Businesses (PRIN)

There are eleven principles of good business practice that have to be met, each starting with the phrase 'A firm must'. These principles are now part of both the PRA's and FCA's handbooks, as follows:

Table 6.2: Eleven Principles for Businesses (PRIN)

Principle	Descriptor
1	Conduct its business with integrity.
2	Conduct its business with due skill, care and diligence.
3	Take reasonable care to organise and control its affairs responsibly and effectively with adequate risk-management systems.
4	Maintain adequate financial resources.
5	Observe proper standards of market conduct.
6	Pay due regard to the interests of its customers and treat them fairly.
7	Pay due regard to the information needs of its clients and communicate information to them in a way which is clear, fair and not misleading.
8	Manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9	Take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.
10	Arrange adequate protection for clients' assets when it is responsible for them.
11	Deal with its regulators in an open and co-operative way, and must disclose to the regulator appropriately anything relating to the firm of which the regulator would reasonably expect notice.

Separate sections in the regulators' Handbooks develop each of these themes more fully. Some principles are expected to be embedded in a firm's operations and procedures and effectively be business as usual, e.g. fair treatment of customers – formerly the TCF initiative.

Activity

Consider whether the following behaviours might give rise to a conflict of interest (see Principle 8). Write 'yes' or 'no' alongside each one first, then ask colleagues for their input.

- A broker retaining clients' money before paying on to insurers.
- Accepting corporate hospitality or gifts.
- A single broker or claims adjuster dealing with claims from two or more clients arising out of the same loss.
- A broker having any authority from an insurer to settle claims.

B5 Fair treatment of customers

The customers are the key to an insurer or a broker's success and without them the organisation would find it difficult to survive. Investors want to receive a return on their equity and to ensure this is achieved, the organisation needs to make a profit. However, to do so at the expense of the customer base, regardless of size, would not be a particularly successful ongoing business model. This is particularly the case in a market place which is generally oversupplied with insurance capacity, thus allowing customers the opportunity to take their business elsewhere.

Principle 6 states that 'a firm must pay due regard to the interests of its customers and treat them fairly'

Principle 6 states that 'a firm must pay due regard to the interests of its customers and treat them fairly'.

The FCA expects those authorised to be able to show consistently that fair treatment of their customers is at the heart of their business model. They have defined this to mean addressing the fair treatment of customers throughout the product life-cycle, as follows:

'Fairness' covers a series of values and depends on the specific circumstances of each case. The FCA's principles-based approach means there is no prescriptive checklist for compliance with this requirement. However, it has issued guidelines on what is (and what is not) appropriate behaviour. Remember that the FCA's primary focus is the protection of consumer customers rather than large commercial clients who are expected to be more sophisticated in their knowledge both of insurance and the products on offer.

Activity

What would you personally consider to be unfair behaviour by an insurer? Think about product information, the sales process and the claims process. Ask six friends not involved in the insurance business whether they have ever had an experience with an insurance company that they considered to be unfair and make some notes as to what behaviour they felt was unfair.

In your view, were all of the 'unfair' experiences described by your friends truly unfair? Do any of them simply represent an outcome with which your friend (the customer) disagreed – but which was actually fair?

Many insurance-related products are complex

Many insurance-related products are complex and the level of consumer understanding is relatively low unless the consumer happens to also work in the insurance industry.

This means that there could potentially be times when a customer is satisfied simply because they do not realise that they have been unfairly treated. On the other hand, a customer who had unrealistic expectations may be dissatisfied, even though the firm knows that it has treated them fairly.

Consider this…

An insured purchases a policy and receives with it documentation setting out clearly what is covered and what is excluded. They do not bother to read the documentation. Some time later they have a loss and make a claim. The insurer declines the claim because there is a clear exclusion in the policy and sets the reasons out clearly in a covering letter.

The insured complains because they did not expect any claims to be declined.

Do you consider that the insurers have treated them fairly by firstly providing clear supporting material at the time of placement and then with the letter setting out the reasons for the claim being declined?

A firm, whether it's an intermediary or insurer dealing directly with clients, must develop procedures out of an adequate knowledge of the markets and its particular expertise in creating appropriate solutions for its clients. Where a customer is known to be less knowledgeable, the firm must explain things in greater detail.

For all clients, it is necessary to understand their needs and to meet those needs with the most appropriate product.

Consumers and commercial customers

The FCA draws a distinction between two different types of clients.

A **consumer** is defined as a natural person who is acting for purposes which are outside their trade or profession.

A **commercial customer** is a customer who does not fall into the consumer definition.

This is an important distinction as there are different rules and obligations to customers under FCA rules depending on whether they are one type or the other.

Here are some examples of the distinction:

- Individual purchasing personal motor insurance is a consumer.
- Individual purchasing motor insurance for all the cars owned by their company would be a commercial customer.
- Individual buying house insurance for their home is a consumer.
- Individual buying house insurance for a property bought to let out is a commercial customer.

This distinction is very important particularly in relation to concepts such as the fair treatment of customers which apply only to consumers but are of course good practice to apply to commercial customers as well.

Promised service levels must be delivered to customers so that they are protected from unpleasant surprises arising from the products they buy.

A firm must treat its customers fairly and have appropriate controls in place to ensure this is the case

When developing a new product the FCA requires a firm to identify its inherent level of risk. It is the FCA's view that customers should not be exposed to unsuitable or unidentified risks arising from a newly developed product. A firm must treat its customers fairly and have appropriate controls in place to ensure this is the case.

A good example of a new product would be a contract where the firm actually delegates some underwriting authority to someone else (perhaps a broker). This type of contract (often known as a binding authority) carries more risk for the insurer as it is allowing day-to-day control of the contract out of its own hands.

The FCA is not expecting customised products for each customer, otherwise the market would grind to a halt owing to soaring costs. However, the FCA expectations mean that a firm must consider its target market. The systems and controls it puts into place must be such that they ensure the firm's actions are likely to be fair for that target market.

Consumer responsibility

Note that the FCA also expects consumers to take responsibility for their decisions where they have the understanding and information to do so.

Activity

Imagine you are putting together a product covering personal possessions for students in halls of residence. Consider what you should do to ensure that you cover all the requirements of the fair treatment of customers.

Conduct risk

Lloyd's has produced a set of conduct risk standards which are tailored to the operation of the Lloyd's market. They deal directly with how best to treat customers fairly and they apply to **all customers** – both consumers and businesses. However, the different level of understanding of insurance by a consumer and a business should be recognised, hence, insurers' behaviour towards each group must take this into account, for example, by the way in which they communicate.

See: www.lloyds.com/the-market/operating-at-lloyds/lloyds-minimum-standards/conduct-risk.

B6 Senior Management Arrangements, Systems and Controls (SYSC)

These provide greater definition of Principle 3. A number of controlled functions, relating to roles that must be carried out in an authorised firm, are defined in the rules. The most significant of these is the **Apportionment and Oversight Officer**.

The Apportionment and Oversight Officer is responsible for the allocation and monitoring of regulated activities within the firm.

The Apportionment and Oversight Officer is responsible for the allocation and monitoring of regulated activities within the firm

There is a requirement within SYSC for insurers and intermediaries to appoint a Money Laundering Reporting Officer (MLRO) who has overall responsibility within the firm for the establishment and maintenance of effective anti-money laundering systems and controls.

Money laundering is quite simply the process by which criminals attempt to conceal the origins of the proceeds of crime.

Money laundering is dealt with in more detail in chapter 7

Activity

Find out who the MLRO is in your firm and what they do.

B7 Public Interest Disclosure Act 1998 (PIDA)

The **Public Interest Disclosure Act 1998** (**PIDA**) concerns 'whistle-blowing', which is the public allegation of a firm's concealed misconduct, usually from within the same organisation. Put rather more childishly, it could be likened to telling tales, although the subject-matter is generally far more serious.

The Public Interest Disclosure Act 1998 (PIDA) concerns 'whistle-blowing'

The Act was born out of a desire to encourage a culture of openness within an organisation on the basis that prevention is better than cure.

PIDA states that individuals who make qualifying disclosures of information in the public interest have the right not to suffer detriment by any act or omission of their employer because of the disclosure. The technical term for 'whistle-blowing' is 'making a qualified disclosure'.

Protected disclosures

The PIDA makes it unlawful for an employer to punish an employee (for example, terminate their employment) for whistle-blowing as long as the report was made in good faith.

The term protected disclosure is used to define a qualifying disclosure made by an employee and links PIDA with employment rights legislation so as to ensure that employees making qualified disclosures cannot be discriminated against by reason of having made that disclosure.

A qualifying disclosure is one which, in the reasonable belief of the worker, tends to show that one or more of the following has been, is being, or is likely to be committed:

- a criminal offence;
- failure to comply with any legal obligation;
- miscarriage of justice;
- putting off health and safety of any individual in danger;
- damage to the environment; and
- deliberate concealment of any of the above.

Application of PIDA

PIDA does not just apply to the financial services industry. For example, say a factory owner deliberately fails to provide appropriate safety equipment (such as gloves, steel toecap boots or guards on machinery) to staff performing a dangerous task. In this case, the whistle-blower should go to the Health and Safety Executive to report the factory owner.

Firms are encouraged by the FCA to adopt appropriate internal procedures encouraging workers to 'blow the whistle' internally when they are concerned about FCA-related matters. However, a wise employer would not restrict this solely to FCA issues.

For a larger firm, such appropriate internal procedures may include a statement of intent that the firm takes failures seriously and which indicates what it regards as a failure. Written procedures should show respect for the confidentiality of workers who raise concerns and describe how such concerns may be raised (outside the usual management structure and, if necessary, outside the firm).

The firm should consider offering access to an external body, such as an independent charity, for advice. The procedures should also describe the penalties for making false and malicious allegations and ensure that once a worker has made a protected disclosure they are not victimised. In addition, they should make their whistle-blowing procedures accessible to staff of their key contractors.

The FCA acknowledges that a less wide-ranging set of procedures may be appropriate for smaller firms.

Activity

Locate your company's whistle-blowing procedures and familiarise yourself with them.

Question 6.1

An insurer refuses to purchase employers' liability insurance even though it is compulsory by law. If an employee reports their employer to the appropriate authorities for this breach, what is this technically known as?

a. Making an appropriate report ☐

b. Whistle-blowing ☐

c. Making a qualifying disclosure ☐

d. Collaborating ☐

C Overseas regulation

In this section, we will review the mechanisms by which insurers located in the London Market can underwrite risks from overseas, and the various requirements that are imposed in order for them to do so.

C1 Companies writing business overseas

Generally speaking, if an insurance company based in London wishes to write business in another country it must be admitted by the regulator in that country and as a requirement of admittance often has to set up offices, employ staff and incur capital expenditure in the start-up of the new office.

If an insurer is authorised in its 'home state', it can operate freely in all other EU countries

If an insurer is authorised in one country within the EU, known as its 'home state', then it can operate freely in all other EU countries – presenting a slight advantage for the EU over other territories as a location for investment. This system is known as 'home state financial regulation' and works on the basis of the regulators in each EU country respecting the regulatory work of their colleagues in the other countries and not feeling the need to repeat the work.

What this also means in practice is that the companies operating in the EU can make business decisions about whether to open offices in other EU countries or just operate from their home location, as follows:

- If they choose to open offices or establish a physical presence in another EU state, this is known as working on an 'establishment' basis.
- If they choose to work only from their home state, this is known as a 'services' basis.

Although the EU regulators will not repeat the work of their colleagues in other countries in respect of authorising insurers to operate in their home countries, local rules and regulations still apply which insurers need to adhere to. These will be discussed in more detail in chapter 7.

Activity

The benefit of being within the EU led Lloyd's to open an insurance company in Brussels which will write business from 2019. Other London Market insurers are also considering opening up bases in the EU.

Read this article about Markel opening up an EU base in Munich:

http://bit.ly/2k7bxRn

C1A Companies writing business in the USA

Insurers from outside the USA must obtain permission multiple times to access business emanating from across the USA

Insurance regulation in the USA is left to individual states to manage and hence insurers from outside the USA must obtain permission multiple times to access business emanating from across the USA. The state regulators can grant permission to foreign insurance companies to write business alongside local insurers on what is known as an **admitted basis**, but many state regulators require the submission of wordings and rates (premiums) to be agreed.

What this means in practice is that the admitted insurers have to allow the regulators to review all the policy wordings that they intend to use and also the premiums that are going to be charged. This has the potential to be quite restrictive for insurers as they obviously should not deviate from those wordings and premium rates that they have submitted. The regulators, of course, can and will offer comments on both the wordings and the rates and can require amendments before they can be used. Lloyd's and in fact many insurance companies write US business on what is known as a 'surplus lines basis' which removes the need for all the filing of wordings and premium rates with the regulators.

C2 Lloyd's writing business overseas

The Lloyd's Market enjoys an unusual position as Lloyd's itself undertakes to obtain permission from international regulators – and that central permission for the Lloyd's Market applies to any syndicate operating within that Market. From a logistical perspective, this provides a significant benefit to any insurer operating within the Lloyd's Market as the negotiations are conducted centrally on behalf of the whole Market and in most countries (not all as we will see later in this section) the insurers do not have to set up any further offices outside London.

The Lloyd's Market does not have permission to write all types of business in every country and in some countries, only reinsurance business (not direct insurance) can be written.

In June 2010, Lloyd's was granted a licence to write direct business from China which sits alongside the reinsurance licence it has held for a number of years.

Reinforce

In many countries, the government wants local risks written in the local insurance market to keep premium funds within the country's borders. In reality these risks are often too large for the local insurers to keep themselves and so they will obtain reinsurance from the international market (often London).

Activity

Go to www.lloyds.com/The-Market/Tools-and-Resources/Tools-E-Services/Crystal and see what activity Lloyd's insurers are authorised to undertake in various countries around the world. Think about the risks that you might see either as an insurer or a broker and where they come from.

Lloyd's has representatives and offices in certain countries around the world and some offices also have underwriters present from various syndicates to accept risks from local brokers.

Lloyd's has representatives and offices in certain countries around the world

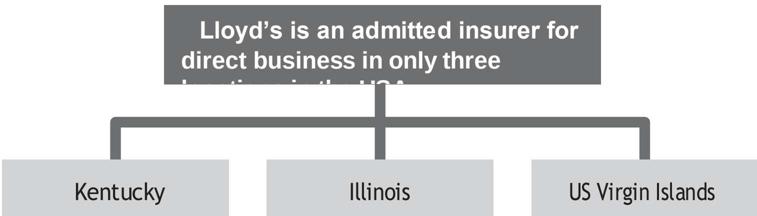
The opening of the Lloyd's base in Singapore is a good example of how the market has extended to the customer. The Lloyd's physical marketplace has essentially been replicated on a smaller scale in Singapore with a number of syndicates setting up operations in one building – a mini 'underwriting room' in effect where brokers can visit a number of different syndicates within one building.

Activity

What do you think are the benefits of having underwriters located in Singapore for both the insurers and their clients?

C2A Lloyd's writing business in the USA

The same provisions concerning individual state regulation apply equally to Lloyd's as to companies. In the USA, Lloyd's has obtained centralised authority for the syndicates to write business but it does vary from state to state.



Lloyd's is an admitted insurer for direct business in Kentucky, Illinois and US Virgin Islands

This status means that Lloyd's syndicates have the same rights as local insurers in those states. However, with those rights also comes restrictions – particularly the need to file wordings and rates (premium rates) with the regulator. This provides some inflexibility in the way in which syndicates can deal with any business coming out of those locations.

In all other locations in the USA, Lloyd's has – for direct business – what is known as surplus lines status. Insurance companies can also have this status. What it means is that the Lloyd's Market is a second-tier market, which can only be accessed if the local or admitted market is not able to accept the risk. The reason that the local or admitted market is not able to accept the risk could be due to the size or complexity of the risk; however, the regulator will, if the placement in the surplus lines market is challenged, need to see that the risk was offered to the local market first.

The rules for accessing the surplus lines market vary from state to state, but generally, involve the risk having to be shown to a number of local insurers first.

Lloyd's is fully authorised in all 50 states to accept reinsurance business with no limitations. Just to confuse everybody, Lloyd's holds both admitted and surplus lines status for direct business in Illinois, Kentucky and the United States Virgin Islands.

?

Question 6.2

What is the key difference between Lloyd's and Company Markets in relation to the obtaining of permission to write overseas business?

a. There is no difference ☐

b. Lloyd's obtains the permission centrally for all syndicates whereas companies have to get individual permission ☐

c. IUA obtains permission centrally and Lloyd's syndicates have to obtain individual permission ☐

d. Lloyd's has to open overseas offices, however, IUA companies do not ☐

C3 Satisfying overseas regulators

Lloyd's does the reporting centrally on behalf of all the syndicates

As a condition of granting Lloyd's licences to write business coming out of their country, most regulators impose a number of requirements, generally centred around reporting and the payment of various taxes. These requirements are also imposed on any companies given authority; however, the key difference is that Lloyd's does the reporting centrally on behalf of all the syndicates but each insurance company has to report to the regulators individually.

The reporting requirements vary dramatically from country to country, for example:

- Some countries are only interested in the category of risk:
  - direct, facultative reinsurance, excess of loss reinsurance or proportional treaty reinsurance.
- Some countries are interested in far more information such as:
  - location of the risk;
  - location of the broker;
  - services or establishment business;
  - tax payable (varying rates possible);
  - other charges payable such as fire brigade charges; and
  - the category of the risk.

The reporting is done based on premium and claims data held on central market databases

The reporting is done based on premium and claims data held on central market databases using coding which is created to permit the level of detail required by each country. Regular reports are taken from the data and submissions made to the individual regulators. Of course, the requirements for the data to be correct are obvious and great care has to be taken to ensure particularly that tax information is captured correctly so that Lloyd's can take the correct funds from the syndicate bank accounts for onwards payment to the tax authorities in each country, including HM Revenue and Customs (HMRC) in the UK.

C4 Insurers that are both Lloyd's syndicates and insurance companies

As we saw earlier, any insurer that has both a Lloyd's syndicate and an insurance company within its group has to consider for each risk that it reviews whether it is authorised to write that risk – both by the local regulators and also by any overseas regulators that might have an interest.

Many underwriters have the authority to bind risks for both platforms and can choose to take a share for one or both entities that they represent.

Activity

Identify seven insurers working in the London Market that are both a Lloyd's syndicate and an insurance company.

D Lloyd's Market governance

In this section, we will review how Lloyd's is regulated in the UK.

The Society of Lloyd's and managing agents are regulated by both the FCA (for conduct of business) and PRA (for prudential requirements) whereas brokers and members agents are regulated by the FCA for both aspects.

The regulators historically drew a distinction between the responsibilities that it placed on the Society of Lloyd's (Lloyd's) and those it placed on the managing agents running the syndicates operating within the marketplace.

The rules that apply to all other regulated insurers also apply to Lloyd's. In essence, the regulators wish to ensure that anyone insured within the Lloyd's Market is at least as well-protected as if they had been insured by any other authorised insurer.

The rules that apply to all other regulated insurers also apply to Lloyd's

The regulators also allow the Lloyd's Market to enjoy some flexibility in sharing out the responsibility for controlling the various risks. Lloyd's is required to undertake the following:

- Ensure that all participants in the market are made aware of their obligations.
- Create and maintain controls over the risks to which the Lloyd's Market is exposed and thus impacting on funds held and managed centrally.
- Measure and assess the capital needs of each member or Name. The capital need is measured by looking at a member's involvement in various syndicates across the market; it also takes into account the various types of business in which the syndicates they support are engaged.

The managing agents are obliged to undertake the following tasks:

- File an annual solvency test return (showing that their assets constantly exceed their liabilities to the required level).
- Assess the capital needed in order to engage in the insurance business planned for each syndicate under their control.
- Put into place and maintain controls over risks that relate to the day-to-day insurance business such as market risks and credit risks.

Activity

Think about the credit risks that a syndicate might run in relation to failure to pay a premium – what steps could they take to minimise this risk?

Consider the same risk in relation to a reinsurance policy not paying claims because a reinsurer has gone out of business – what can an insurer or a broker do to minimise this risk?

Question 6.3

What is the key concept that underpins the regulator's willingness to allow Lloyd's a degree of self-regulation?

a. Insureds must have the same degree of protection as if insured by a non-Lloyd's insurer ☐

b. Insureds have better terms and conditions than they would obtain from a non-Lloyd's insurer ☐

c. Insureds always obtain a formal policy document ☐

d. Lloyd's must always control the risks centrally ☐

D1 Lloyd's governance structure

Various pieces of legislation impact upon Lloyd's, the most obvious being the various **Lloyd's Acts** passed between 1871 and 1982 (and the Variation Order to the 1982 Act that came into force in late 2008). The two key bodies in this model are the Council of Lloyd's and the Franchise Board.

Activity

Visit www.lloyds.com and find out more about the history of Lloyd's including the governance structure.

D1A Council of Lloyd's

The Council of Lloyd's remains the governing body of the Lloyd's Market

The Council of Lloyd's remains the governing body of the Lloyd's Market (or to put it more correctly the Society of Lloyd's). It has the following powers:

- rule-making power – can create market 'laws' known as byelaws;
- management and superintendence of all affairs of Lloyd's;
- right to exercise any of the powers of the Society of Lloyd's; and
- power to direct the insurance business at Lloyd's.

Certain activities that only Council can undertake include:

- making or changing byelaws;
- setting the long-term strategic development of the market;
- deciding contribution levels to Lloyd's Central Fund (covered in more detail in study text *LM2: London Market insurance principles and practices*);
- deciding the amounts of members' (Names') annual subscriptions;
- appointing members of Council and of the Franchise Board; and
- reviewing budgets and plans from the Franchise Board – particularly the three-year plan from the Franchise Board.

Members of Council

Council is made up of 18 members, who comprise working, external and nominated members. The post of Chairman of the Council is always held by the current Chairman of Lloyd's.

Reinforce

Do you recall the definitions of the three types of members that make up Council? If not, you can re-visit chapter 5, section A1.

Activity

Go to www.lloyds.com/lloyds/corporate-governance/council-of-lloyds

Are any of the current Members of Council linked to the organisation you work for?

The members of Council are strategic decision-makers but do not engage in the everyday management of the work of Lloyd's. This is done by an executive team of the Corporation of Lloyd's.

Activity

Find out more about the executive team by visiting: www.lloyds.com/lloyds/corporate-governance/executive-team

Question 6.4

What are the three types of member that make up the Council of Lloyd's?

a. Underwriting, claims and broking ☐
b. Working, outside and broking ☐
c. Working, external and nominated ☐
d. Operational, external and nominated ☐

D1B Franchise Board

The regulators distinguish between the requirements that they make of Lloyd's centrally and the individual managing agents. Many of the requirements that they place on Lloyd's involve Lloyd's taking reasonable steps to ensure that systems and controls are in place and maintained by the managing agents.

The Franchise Board is responsible for the day-to-day management of the Lloyd's Marketplace

The Franchise Board is responsible for the day-to-day management of the Lloyd's Marketplace. It lays down guidelines for all syndicates and operates a business planning and monitoring process to safeguard high standards of underwriting and risk management – thereby improving sustainable profitability and enhancing the financial strength of the market.

This also seeks to achieve satisfaction of the regulator's obligations on Lloyd's outlined earlier in this chapter. The Franchise Board together with Council have a joint aim which is: 'To maintain, in accordance with Lloyd's Acts, an organisation that will enable the long-term return from carrying out the business of insurance to be maximised for capital providers (i.e. Lloyd's members)'.

The functions of Council and the Franchise Board, together with the accountabilities that link the two bodies together, are all focused on the single aim of providing a marketplace that remains flexible whilst ensuring that the appropriate protections are in place both for the policyholders and the investors (i.e. the members).

The Franchise Board has a significant number of members from outside the market which is in line with best practice in corporate governance.

Consider this…

What is the advantage of having external parties involved in an entity such as the Franchise Board?

Activity

Find out how many non-executive directors sit on the board of the organisation you work for. If possible, find out who they are and what experience they bring to the business.

Useful website

Find out more about the Franchise Board at: www.lloyds.com/lloyds/corporate-governance/lloyds_franchise_board

The Franchise Board has to operate within the boundaries set down by Council.

- overriding principles of legal, regulatory and corporate governance
- capital principles which are balancing the various capital providers and exercising caution and
- operating principles, putting in place market supervision in line with regulatory requirements

The responsibilities of the Franchise Board fall into five main categories:

- setting the framework for market supervision
- admitting and removing participants in the Lloyd's Market
- determining guidelines for participants in the
- approving the annual plan and budget for Lloyd's
- executive appointments, roles and compensation

The Franchise Board seeks to achieve its goals by using a Performance Framework of Minimum Standards on which all managing agents will be measured.

Responsibility for meeting the Lloyd's Underwriting Principles and Minimum Standards rests with each managing agent's board, whether their underwriting is undertaken in house, whether any underwriting authority is delegated to a third party (or parties), or whether underwriting-related services are procured externally.

Activity

Review this website and take a closer look at the minimum standards. If you work for a managing agent, ask a senior colleague how your organisation evidences compliance with any of the standards.

https://www.lloyds.com/the-market/operating-at-lloyds/lloyds-minimum-standards

D2 Rules operating within Lloyd's

As mentioned earlier, Lloyd's is permitted to create some laws that govern the operation of the marketplace. These laws come in two forms:

Byelaws and regulations	These are known as primary rules and set out the fundamental concepts.
Requirements	These are known as secondary rules; they contain the detail of what needs to be undertaken to comply with the primary rules. They are also structured in such a way as to allow efficient updating and amendment if required, even if the actual byelaw remains the same.

Byelaws and regulations are known as primary rules and set out the fundamental concepts

Lloyd's often issues additional guidance to either type of rules called Explanatory Notes; these are not rules but should be read alongside the rules to aid interpretation. They also issue Codes of Practice which provide operational detail as to compliance with the Rules.

Activity

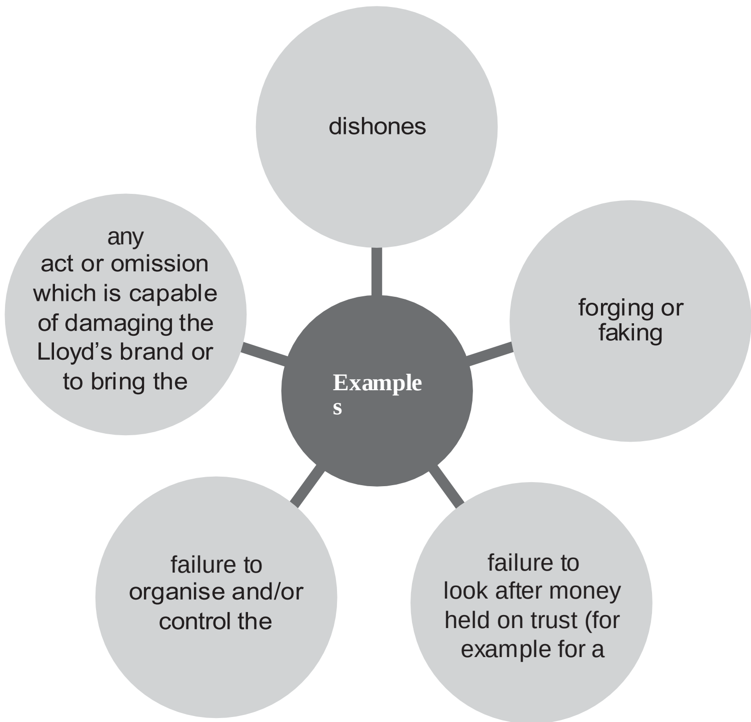
Review this Code of Practice and see how it fits in with primary and secondary rules: http://bit.ly/2yxEQis

Lloyd's has enforcement jurisdiction over anyone working within the Market

Not surprisingly, having made rules and set standards for the market, Lloyd's takes any breaches of those rules very seriously. Lloyd's can take enforcement proceedings in relation to any behaviour that it regards as a breach of any Rules or bringing discredit to the Market. This is known as having enforcement jurisdiction. The FCA also has disciplinary functions should any of its rules be breached and the two parties work together so as not to duplicate each other's functions in this area.

Anyone working within the Market, whether for managing agents, members' agents or involved through being a member is covered by the enforcement jurisdiction of Lloyd's. The jurisdiction covers the companies as well as the individual staff employed by them. The penalties that Lloyd's can impose range from fines through to lifetime bans from the market.

As guidance, Lloyd's indicates what sort of behaviour it regards as less than acceptable.



Question 6.5

What are the two main types of regulation that Lloyd's issues for the Market?

a. Byelaws and requirements ☐
b. Codes of practice and byelaws ☐
c. Requirements and explanations ☐
d. Byelaws and codes of practice ☐

E Authorisation of new insurers

Any UK domiciled company wishing to transact insurance in the EU must be authorised by the UK regulator (PRA) to do so. To gain this authorisation, the regulator must be satisfied that the company complies with its requirements. The objective is that only companies operated by 'fit and proper' persons should be authorised to transact business. In brief, the regulator has the power to authorise a company to transact general business and can also restrict authorisation to specific classes of general insurance, such as accident, damage to property or general liability.

Any UK domiciled company wishing to transact insurance in the EU must be authorised by the UK regulator (PRA) to do so

Reinforce

Can you recall what you learned about home state regulation earlier in the chapter? If not, re-visit section C1.

Companies based outside the UK, but in a Member State of the EU, and wishing to transact business in the UK must satisfy similar requirements in their home state. When a UK-based insurance company decides that it wishes to transact insurance, it has to complete and submit detailed forms to the regulator. The information given on these forms is used by the regulator to satisfy itself that the company is financially sound, that its markets, administration and premium structure are sound and that its key personnel are 'fit and proper' persons.

For corporate newcomers to the Lloyd's Market, three main options for participation are available, as follows:

- Set up a new corporate member or Name to participate in syndicates that already exist.
- Set up a new corporate member or Name and a new syndicate.
- Set up a new corporate member or Name, a new syndicate and its own managing agent to run the syndicate.

The last option is essentially the same concept as setting up a new insurance company – all the elements are in one place.

Activity

See also the PRA's website under 'Authorisations': www.bankofengland.co.uk/pra. This will give more information about the preparatory work that an insurer should do before applying for authorisation.

If someone wants to set up a new business within Lloyd's, then Lloyd's needs to agree as well. In the first instance, it will want an outline briefing covering the main elements of people, plan, capital, reputation and value. This briefing forms the basis of discussion at a meeting with a member of the Lloyd's relationship management team, which will cover:

- the opportunity;
- the applicant's strategy and background;
- the structure of the proposed new business (size, structure and aims);
- classes of insurance and territories in which they want to be involved;
- underwriting and management resources;
- details of their proposed managing agent;
- sources of capital; and
- their value to Lloyd's.

If Lloyd's believes their outline proposal has the potential to meet its entry requirements it will invite them to move to the first formal stage of the process.

See chapter 7 section A4 for further information on Solvency II

Solvency and capital adequacy are discussed in more detail in study text LM2

Part of the initial requirements for setting up any new insurer, whether it be company or Lloyd's is satisfactory evidence of solvency and capital adequacy. Solvency and capital adequacy are discussed in more detail in study text *LM2*, but the basic concept is ensuring that assets always exceed liabilities.

E1 Capital adequacy

A solvency margin is the amount by which assets must exceed liabilities

A solvency margin is the amount by which assets must exceed liabilities. Each company (and Lloyd's) must maintain a minimum balance between its assets and how much it knows it has to pay or would be likely to pay in liabilities.

However, in common with other areas of regulation, the regulators historically had a risk-based approach to insurers' capital requirements, the detail of which is outside the scope of this syllabus. The concept of capital adequacy, however, is that the equation also has risk elements factored in, for example, the types of insurance written by the insurer. Certain more volatile types of insurance require more weight on the assets side of the equation.

E2 Monitoring

Regular monitoring is an important supervisory aspect of the work of the FCA

Clearly, it is not sufficient for the regulator simply to establish a system for the authorisation of applicant insurers and for determining solvency margins. They need to ensure that these standards are maintained. Regular monitoring is, therefore, an important supervisory aspect of the work of the regulator.

Each financial year, every authorised insurer must prepare and submit to the regulator as part of the monitoring process the following items:

- **revenue account** – shows the underwriting profit or loss;
- **profit and loss account** – (also known as an income statement) shows the total profit and loss made; and
- **balance sheet** – shows the assets and liabilities of the organisation at any given point in time.

As we have already seen in section B, in addition to the reports the regulator will consider each authorised firm, and analyse the degree of risk that the firm presents. The Financial Conduct Authority uses a three pillar system involving analysis of the risks that the business's conduct presents.

Pillar 1
Proactive Firm Supervision

Pillar 2
Event driven work

Pillar 3
Issues and products

The PRA uses a supervisory framework based on the perceived level of risk (see Table 6.1).

E3 Winding-up

The regulation and supervision of intermediaries is covered in chapter 8

Ultimately, if an insurance company fails to meet its requirements, the regulator can intervene and the company can be wound-up (i.e. the formal cessation of the company). A Lloyd's syndicate can be put into 'run-off' (which prevents it from taking on any further business).

The term 'run off' means that the insurer cannot write or accept any more new risks

The term 'run off' can be used for both Lloyd's syndicates and insurance companies and the term means that the insurer cannot write or accept any more new risks. The policies already in force will usually be allowed to run naturally to their expected expiry. Of course, the insurer's liability does not finish when the policy expires as some types of policy will have claims that take a long time to be concluded, such as liability insurances with personal injury claims.

F Financial Ombudsman Service (FOS) and the Financial Services Compensation Scheme (FSCS)

In this final section, we will review the role and powers of the Financial Ombudsman Service (FOS) and the Financial Services Compensation Scheme (FSCS). They both play a part in the control of the insurance market although their input tends to be triggered by claims and lessons to be learned from the way in which claims have been handled.

F1 Financial Ombudsman Service (FOS)

The FOS is an independent body and works closely with the FCA for the purposes of co-operation and communication as they carry out their independent roles. Membership is compulsory for all authorised insurers (including, of course, Lloyd's insurers) and other authorised firms, including intermediaries.

Membership of the FOS is compulsory for all authorised insurers and other authorised firms, including intermediaries

The FOS aims to provide both impartial and independent resolution of disputes between either insurer and policyholder or intermediary and client. Although the vast majority of cases referred to it involve claims, any cause for complaint is investigated.

The FOS deals with disputes only where the insured is either a private individual or a small commercial entity with a turnover of less than €2m and fewer than 10 employees (trusts and charities with an income of less than £1m are also eligible).

Activity

Research the involvement of the FOS in complaints about mis-selling of certain types of insurance at:

www.financial-ombudsman.org.uk/publications/technical_notes/ppi.html

Internal complaints procedures within the authorised firm need to be exhausted before a complaint can be referred to the FOS. The claimant then has a period of six months from the date of the final decision from the firm to refer the matter to the FOS.

For Lloyd's insurance, there is a Lloyd's complaints department which is the first port of call for a complaint about a Lloyd's policy, before the FOS becomes involved.

Consider this…

Why might Lloyd's want to become involved in any complaints about Lloyd's policies? Review the Lloyd's Complaints process here: www.lloyds.com/The-Market/Operating-at-Lloyds/Regulation/Complaints

The maximum financial award that the FOS can make is £150,000, although it can make other awards of a non-financial nature. It may recommend a higher figure, if appropriate, but this will not be binding on the insurer. Anything under £150,000 is binding on the insurer.

The maximum financial award that the FOS can make is £150,000

The insured can either accept or reject the FOS decision. If they accept the decision, the insurer or intermediary has to pay an award, up to a monetary limit. However, if the insured rejects the decision, the insured can still choose to issue legal proceedings. However, if legal proceedings are already under way, the FOS will require them to be suspended before any consideration of the complaint.

Question 6.6

A large chocolate manufacturer with an annual turnover of £20m (€22.5m) has a property insurance covering one of their factories. A claim for fire damage is declined by the insurer and having complained unsuccessfully to the insurer the chocolate manufacturer decides to go to the FOS. Will the FOS be able to assist them?

a. No, FOS only assists individual insureds ☐

b. No, FOS only assists commercial insureds where the turnover is less than €2m ☐

c. No, FOS only assists insureds with personal lines policies ☐

d. Yes, FOS will assist them ☐

F2 Financial Services Compensation Scheme (FSCS)

The FSCS falls under the control of the FCA and provides compensation for customers of deposit-taking companies and investment firms, as well as for those of authorised insurance companies and intermediaries. It, therefore, covers claims against firms where they are unable, or likely to be unable, to pay claims against them. Usually, this is when a firm has become insolvent or has gone out of business. The scheme was set up mainly to assist private individuals – although small businesses, charities and trusts are also covered, broadly in line with the accessibility criteria for the FOS.

Operation of the FSCS

The FSCS reviews the company concerned and only when it is satisfied that the company is unable or is likely to be unable to pay claims, then the FSCS declares the company to be 'in default'. This declaration starts the process of allowing claims to be made against the FSCS compensation pot.

In order to protect the compensation pot, the FSCS seeks to ensure that there is absolutely no chance of the company concerned being able to pay claims.

Insurance policyholders are protected if they are insured by authorised insurance companies under contracts issued in the UK (and in certain cases the European Economic Area (EEA), the Channel Islands or the Isle of Man). The scheme covers compulsory, general and life insurance and is usually triggered if an insurance company goes out of business or into liquidation.

The amount of compensation that a policyholder can receive depends on the type of policy (i.e. whether it concerns compulsory insurance, non-compulsory insurance or long-term insurance).

- Protection is **100%** for:
  - **compulsory insurance (third party motor and employers liability)**;
  - **professional indemnity insurance**;
  - **long-term insurance (e.g. pensions and life assurance)**; and
  - certain claims for injury, sickness or infirmity of the policyholder.
- Protection is **90%** of the claim with no upper limit for **other types** of policy, including **general insurance advice and arranging**.

The compensation pot is funded by a levy on all authorised firms.

The compensation pot is funded by a levy on all authorised firms

F3 Lloyd's position

Lloyd's has a rather unusual position in that it maintains its own central pot of money as a contingency in case the members that underwrote the risk are not in a position to pay claims. This reserve fund is known as the **Central Fund** and forms part of the Lloyd's chain of security. This security allows Lloyd's to state correctly that no valid insurance claim has ever gone unpaid in its long history.

More about Lloyd's chain of security and the Central Fund can be found in study text *LM2*.

Key points

The main ideas covered by this chapter can be summarised as follows:

Overview of the regulators in the UK

- The three regulators in the UK are the Financial Conduct Authority, the Prudential Regulation Authority and the Financial Policy Committee of the Bank of England.
- The Financial Services Act 2012 sets out how the regulators operate.

Operation of the FCA and PRA

- The FCA is responsible for consumer protection, integrity and competition.
- The PRA is responsible for promoting the safety and soundness of all its regulated persons and for the insurance industry will have the aim of contributing to the safety and security of those who may become policyholders.
- Society of Lloyd's is regulated by both FCA and PRA as are managing agents.
- Brokers and Members' agents are regulated solely by the FCA.

Overseas regulation

- Insurers wishing to write risks from overseas will also have to comply with local regulators' requirements, although within the EU there is flexibility resulting from each country recognising the quality of the others' regulators.
- For the USA the regulation is provided on an individual state basis.
- Surplus lines underwriters are not admitted in a particular country or state but act as an additional market should the local admitted market not be able or willing to accept the risk.
- Lloyd's facilitates compliance with overseas regulation centrally, but insurance companies have to engage with the regulators individually.

Lloyd's Market governance

- The Council of Lloyd's is responsible for the management and supervision of the Market.
- Franchise Board is responsible for the day-to-day operational management of the Market.
- Franchise Board has performance standards by which it sets out the requirements for managing agents operating within the Market.

Authorisation of new insurers

- The FCA and PRA set out standards that have to be met to become authorised, and to remain authorised to conduct business as an insurer.

Financial Ombudsman Service (FOS) and the Financial Services Compensation Scheme (FSCS)

- The FOS exists to provide an impartial and independent final mechanism for the handling of complaints against insurers and intermediaries. It handles complaints from individuals, small commercial entities with a turnover up to €2m and fewer than 10 employees, and trusts and charities with an income of less than £1m.
- Lloyd's has its own complaints department which acts in relation to complaints about Lloyd's policies to attempt resolution before the matter reaches the FOS.
- The FSCS exists to compensate policyholders if their insurer is unable to pay a valid claim. They will deal only with individuals and small commercial clients generally with the exception of employers' liability policyholders which are eligible irrespective of size because this insurance is compulsory.
- The amount of compensation depends on whether the insurance is compulsory, general or long-term and also the date at which the company went into default.

Question answers

6.1 The correct answer is c.

6.2 The correct answer is b.

6.3 The correct answer is a.

6.4 The correct answer is c.

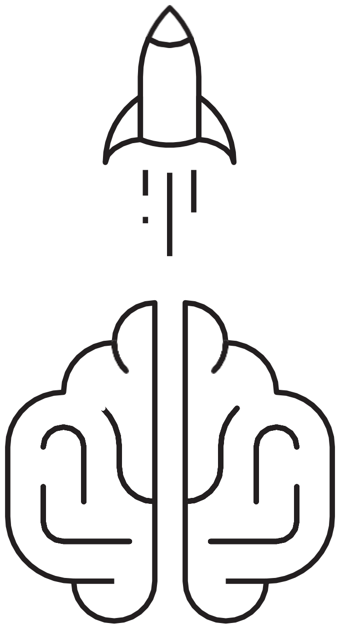
6.5 The correct answer is a.

6.6 The correct answer is b.

Self-test questions

1.	Which organisations regulate the UK insurance market and from what piece of legislation do they obtain their authority?
2.	What are the main objectives of the FCA?
3.	Identify any three of the threshold conditions that the PRA require to be met when becoming authorised.
4.	Briefly outline the concept of fair treatment of customers.
5.	What is meant by whistle-blowing? Give an example.
6.	Briefly describe the concept of home state regulation within the EU.
7.	How do Lloyd's syndicates obtain permission to write business in other territories?
8.	List three of the powers which are only held by the Council of Lloyd's.
9.	What are the three categories of Members of Council?
10.	Which organisation will become involved if an insurance company is unable to pay its claims?

You will find the answers at the back of the book



7

Regulatory processes, systems and controls

Contents	Syllabus learning outcomes
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B Sanctions	8.1
C Data protection	9.1
D Anti-money laundering	9.2
E Bribery	8.2
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Learning objectives

After studying this chapter, you should be able to:

- explain the impact of US, EU and UK legislation on the way in which insurers conduct their business;
- describe the use of systems and controls to ensure that businesses adhere to the necessary legislation;
- explain the purpose of sanctions;
- explain the principles, rights and restrictions of data protection;
- explain the concept of money laundering and the controls used by business to avoid its occurrence; and
- describe the concept of bribery and the issues it presents for the insurance market.

Introduction

In this chapter, we will be exploring the various systems and controls which influence the way business is handled and conducted in the London Market. As we have seen in earlier chapters, only a small portion of business written in the London Market comes from UK-based clients. Therefore, not only the UK regulators but also overseas regulators such as the European Union (EU) have an impact on the workings of the London Market and cannot be ignored.

Systems and controls are internal management tools that are used by businesses to ensure that they can prove that they are in compliance with the various requirements of the regulators. Those systems and controls do not need to be identical for every organisation if they perform the task required of them.

We will also be looking at how and why regulators actively ban the interaction of the Market with certain countries, entities or individuals.

Next, we will look at two areas of control: data protection and anti-money laundering. We will focus on the impact on insurers and their customers.

Finally, we will look at the subject of bribery and the issues that it raises in the London Market.

Key terms

This chapter features explanations of the following terms:

Anti-money laundering	Bribery	Centralised market data	Client verification
Crystal system	Data Controller	Data evidence	Data protection
Data protection principles	Export controls	Financial crime	Financial sanctions
Integration	Joint Money Laundering Steering Group (JMLSG)	Layering	Money Laundering Reporting Officer (MLRO)
National Crime Agency (NCA)	Personal data	Placement	Principal money laundering offences
Sanctions	Senior Management Arrangements, Systems and Controls (SYSC)	Solvency II	Systems and controls
Tipping off offence	Trade sanctions		

A Impact of UK, EU and US regulation

Now the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) regulate the whole UK insurance industry (i.e. not just the London Market). However, the London Market writes considerable business from around the world and therefore is impacted by regulation(s) imposed in other countries.

If a London Market insurer wishes to write risks coming from another country, one of the 'prices' that it has to pay is compliance with that country's rules, however burdensome they might appear to be.

The EU also places additional regulation on the insurance industry through the creation of centralised legislation known as directives which take effect in all countries within the EU.

Here, we will look at the systems and controls that London Market insurers must put into place to ensure compliance with those regulations. The fine detail of the various regulations is outside the scope of this syllabus.

A1 Obtaining information about applicable rules

The most obvious starting place for the insurer is to obtain information about any applicable rules and regulations. There will be little sympathy from the regulators if insurers claim that they didn't know about the rules, so could not comply with them.

Lloyd's has centralised departments in its Corporation focused on relations with the UK Government

Lloyd's has centralised departments in its Corporation focused on relations with the UK Government and also with overseas regulators to ensure that it receives information about the rules which can then be circulated to the syndicates. The LMA, IUA and LIIBA also send information to their members.

Not unsurprisingly, there is a requirement from many of the regulators for regular reporting of risks written in their jurisdiction, premiums paid, taxes applicable and claims arising. For Lloyd's most of this reporting is performed centrally by Lloyd's on behalf of the whole market, although the managing agents still retain responsibility for ensuring that data is captured correctly about the risks and claims.

More information about centralised market data can be found in chapter 5.

The main aspects which impact the London Market are non-life, solvency, insurance mediation (which mainly affects brokers), reinsurance and accounting. In practice, unless legislation specifically indicates that it only applies to a certain country, it can be assumed that it is applicable to the London Market.

A2 Planning

Once insurers have clarity as to what is needed, they need to plan to ensure that compliance activities are undertaken in accordance with the requirements and on time. Again, Lloyd's provides some central guidance in this area to help syndicates know what must be done and when.

Activity

Take a look at this website and see what actions are due in the next month:

www.lloyds.com/The-Market/Tools-and-Resources/Tools-E-Services/Business-Timetable?view=list

A3 Data evidence

Regulators require data evidence to show compliance with regulation

In general terms, regulators require data evidence to show compliance with regulation, and this is the basis of the reporting done to them on a regular basis. This data evidence may well be accompanied by payment of monies for taxes in certain countries. In terms of capturing the information for the reporting in the central market risk and claims databases, it is easier to translate the various required pieces of information into codes, which are easier to then report on.

Consider this…

We use codes all the time without realising they are a shorthand way of seeing data. For example, you might regularly catch the No. 42 bus in London. 'No. 42' is in fact a type of code which is a far shorter name for the bus route which might have the full title of 'Hammersmith to Liverpool St, via Aldwych, Ludgate Hill and St Paul's Cathedral'.

A good example of this principle is the coding applied to Lloyd's premium and claims data. This allows analysis of not only the country from which the risk has come but depending on the country's reporting requirements:

- location of the broker;
- location of the risk;
- any premium tax or other tax payable; and
- whether the business is direct or reinsurance.

Activity

Review any systems that you have in your office that hold data. What codes, or shorthand data do you use, perhaps 'USD' for United States dollars?

Question 7.1

What information is not available through the coding applied to premium and claims data in the London Market?

a. Amount of premium being charged ☐
b. Location of the risk ☐
c. Premium taxes payable ☐
d. Whether business is direct or reinsurance ☐

A4 Example of EU regulation: Solvency II

Solvency (simply put: the balance between assets and liabilities) is vital for an insurer to be able to continue trading. The PRA currently requires additional 'padding' of an insurer's assets, the level of which varies according to the classes of business being written. This ensures that the extent to which assets exceed liabilities remains enough to protect the business should a large number of claims be received.

The EU has now introduced Europe-wide solvency rules called 'Solvency II' which according to the EU:

> will introduce economic risk-based solvency requirements across all EU Member States for the first time. These new solvency requirements will be more risk-sensitive and more sophisticated than in the past, thus enabling a better coverage of the real risks run by any insurer.

In practice, this means a change in the system and measures that insurers have to use to demonstrate their solvency. It has the following aims:

- better regulation;
- deeper integration of EU insurance market;
- enhanced policyholder protection; and
- improved competitiveness of EU insurers.

The idea was also to replace 14 current EU directives with one (albeit large) piece of legislation. There was a staged implementation and due to delays in the European Parliament, the implementation finally occurred on 1 January 2016.

Useful websites

Have a look at this EU website for some useful information on Solvency II:

https://ec.europa.eu/info/publications/solvency-ii-directive-transposition-status_en .

Look at the Lloyd's website for useful information including a Solvency II tutorial, successful completion of which earns CPD points!

www.lloyds.com/The-Market/Operating-at-Lloyds/Solvency-II/Information-for-managing-agents/Solvency-II-Online-Tutorial.

Activity

If you work for an insurer speak to your Compliance Officer and find out whether Solvency II has taken up a lot of their time in the last few years.

Activity

If you work for a broker, find out how your firm ensures compliance with the EU Insurance Mediation Directive. Take the opportunity to meet your Compliance Officer.

A5 Systems and controls

Systems and controls go wider than just reporting against regulatory requirements

Systems and controls go wider than just reporting against regulatory requirements but underpin the entire business to ensure that at no time can a risk be written by an underwriter (or an activity be undertaken by a broker) that is in contravention of the rules.

In practice, this means putting in place the safety nets to try and avoid something happening rather than just telling people something has happened after the event.

Reinforce

It is similar to the concept of risk management. Firms can try to avoid bad things happening by using various mechanisms such as training staff.

But what is meant by systems and controls? Is it just setting up the computers with lots of warning messages?

Consider this…

Look at the list of items below that form part of ‘systems and controls’. Are you surprised by any of them? Do you think any are more powerful or useful than others?

- training and education;
- easily accessible information for staff to check;
- operating system controls, warnings and blocks;
- peer review (someone else checking your work);
- system reports to spot problems after the fact; and
- authority limits.

In fact, they are all equally valid and the most important ones are probably training and education. Computer-based checking of processes with inbuilt blocks for certain actions is important, but it is far more important to ensure that staff know why certain things cannot be done, not just know that if they try to do so, that they cannot proceed.

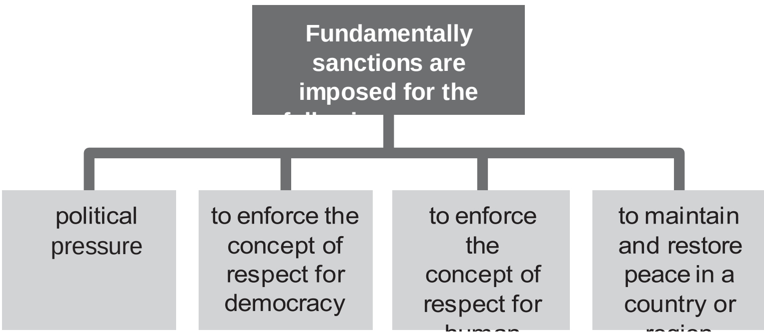
The most important systems and controls are probably training and education

B Sanctions

We have said a number of times in this study text that the vast majority of the business written in the London Market actually comes from overseas clients. International businesses need to be aware of the existence and application of ‘sanctions’. A sanction can be quite simply defined as a ban. Governments around the world can ban all parties (governments, businesses, individuals) from doing business with certain individuals, businesses, governments or even whole countries/regimes. Insurers are required to comply with these sanctions.

Consider this…

What is the point of sanctions? Why are they imposed?



The following sections consider the sanctions issued by the UK Government, the EU, United Nations (UN) and the US Government. Sanctions are imposed as a way of controlling the access to funds for regimes, companies or persons who are felt to be less than desirable – maybe because they have links to terrorism or other unlawful behaviour.

Activity

Review the list of reasons for sanctions above and think about news items that you might have seen recently about countries or governments that might act in a way that will lead to the imposition of sanctions.

Use this link as a tool to start your research:

www.bbc.co.uk/news/world-europe-26672089

B1 UK/EU/UN sanctions

Sanctions in their broadest definition are essentially a ban, but that ban can take different forms

Remember that sanctions in their broadest definition are essentially a ban, but that ban can take different forms. In this section, we will look at bans that are financial in nature, followed by those bans that relate to trade.

Financial sanctions can come in a variety of forms including:

- prohibiting the transfer of funds to a sanctioned country;
- freezing the assets of a company or an individual; and
- freezing the assets of a whole government, as well as the companies and residents of the country concerned.

The Office of Financial Sanctions Implementation (OFSI) in HM Treasury is responsible for the implementation and administration of international financial sanctions in effect in the UK.

The OFSI has the following responsibilities inherited from the Asset Freezing Unit:

- domestic legislation on financial sanctions;
- implementation and administration of domestic financial sanctions;
- domestic designation (principally under the Terrorism Order);
- providing advice to Treasury Ministers, based on operational advice, on domestic designation decisions;
- implementation and administration of international financial sanctions in the UK, including those relating to terrorism, state regimes or proliferation of Weapons of Mass Destruction (WMD);
- working with the Foreign and Commonwealth Office on the design of individual financial sanctions regimes and listed decisions at the UN and EU;
- working with international partners to develop the international frameworks for asset freezing; and
- licensing exemptions to financial sanctions where permitted.

The OFSI provides information on its website to alert users to sanctions imposed by the UK, the EU and the UN.

EU regulations imposing and/or implementing sanctions are part of EU law, are directly applicable and have direct effect in the Member States

EU regulations imposing and/or implementing sanctions are part of EU law, are directly applicable and have direct effect in the Member States. The measures apply to nationals of Member States and entities incorporated or constituted under the law of one of the Member States, as well as all persons and entities doing business in the EU, including nationals of non-EU countries.

B1A Countries impacted by UK/EU or UN sanctions

Certain countries and/or regimes have sanctions against them at any time and the list of them is subject to change.

Activity

Access this website to see the list of countries that currently have sanctions against them. Note also the general grouping called terrorism or terrorist funding.

www.hm-treasury.gov.uk/fin_sanctions_currentindex.htm

Choose any country and click on it to find out more about the specific sanctions that have been imposed.

Remember that sanctions can be applied to individuals or companies as well as governments or regimes.

It is possible to have sanctions lifted

It is possible to have sanctions lifted, and there is a list of what are known as 'lifted regimes' on the OFSI website as well. Those currently on the list include Libya, Haiti and Angola.

In the case of Haiti, the sanctions were imposed in 1991 after a military coup forced the democratically elected president into exile. He managed to seize power again in 1994 and following his return the sanctions were lifted.

Trade sanctions

As well as financial sanctions, there are also separate **trade sanctions** which are managed and monitored by the Department for Business, Innovation and Skills.

Trade sanctions can include travel bans or bans on the import or export of certain cargoes such as oil.

See section B5 for more information about export control.

B2 US Government sanctions

The London Market has very close links with the USA, both through the business coming into the London Market from the USA and also because many of the insurers operating in the London Market have a US parent company.

Reinforce

Can you recall how much business comes into London from the USA and Canada? If not, you will find the answer in the Lloyd's and IUA links given in earlier chapters.

Therefore, it's very important for insurers to understand and comply with any US sanctions, as well as those coming from the UK/EU and UN.

Although many of the countries against which the USA has sanctions are common to the UK/EU/UN list, there are some additions as well as some variations in the extent of the sanctions. See the special information about Cuba in section B2A.

B2A Cuba

US sanctions on Cuba must be complied with by 'all U.S. citizens and permanent residents wherever they are located, all people and organizations physically in the United States, and all branches and subsidiaries of U.S. organizations throughout the world'.

This definition would include any London Market insurer with a US parent.

The Cuban sanctions provisions are very wide-ranging and cover not just business matters but also travel to the country. The salient part of the sanctions is that those entities subject to the rules 'may not provide accounting, marketing, sales, or insurance services to a Cuban company or to a foreign company with respect to the foreign company's Cuba-related business'.

There is a long history between the USA and Cuba and a trade embargo has been in force since 1960, following Cuba's nationalisation of property belonging to US citizens. The **Helms-Burton Act 1996** restricts the conduct of business by US entities with or in Cuba and it is a breach of this law for which insurers have to be watchful.

More information on US sanctions on Cuba can be found in the 'Resource Center' of the U.S. Department of the Treasury website. Although recently US rules in relation to Cuba have been relaxed, the general trade sanctions are still broadly in place.

B3 Practical problems with sanctions

Historically, insurers have had to be watchful for sanctions and be careful not only to whom they sold insurance but also to whom any claims were paid. However, in recent years another problem has arisen whereby sanctions become part of a situation where the offending entity is not a party to the insurance at all.

The situation is piracy, more specifically, the piracy which takes place off the coast of Somalia. 'Piracy' is the act of capturing a ship and her cargo and demanding a ransom for its return. Given the importance of a ship, her cargo and more importantly the safety and well-being of the crew, ransoms are often paid to obtain the release.

'Piracy' is the act of capturing a ship and her cargo and demanding a ransom for its return

The organisations and individuals capturing the ships are shadowy and not necessarily all belonging to the same group or groups; communications may be quite complex to maintain the pirates' cover from the authorities.

Somalia is on the sanctions list of both the UK and the USA. The UK list has several individuals and one group to whom money should not be paid for any purpose.

Somalia is on the sanctions list of both the UK and the USA

However, on 13 April 2010, the USA issued an Executive order which effectively banned any entity with US links from making any payments specifically relating to ransoms to any of a list of individuals and groups (called Specially Designated Nationals or SDNs) annexed to the order, or anyone else that the US Government sees fit to include. The ban also includes routing any money through a US bank.

This could have a major potential impact on London Market insurers as when dealing with pirates, the identity of the direct or indirect recipients of any ransom monies might not be entirely clear. The US order is wide-ranging and pending further clarification, the general guidance for insurers who don't want to risk a breach is that if there are any US involvements anywhere insurers should consult the US Government before any payment is made to pirates.

Activity

Use this link to read the US Executive order:

www.treasury.gov/resource-center/sanctions/Programs/pages/somalia.aspx

B4 How do insurers find out about sanctions?

Substantial information is available on both the websites for HM Treasury and the US Department of the Treasury, OFSI and Office of Foreign Assets Control (OFAC).

Lloyd's insurers and brokers can also access the **Crystal** system on the Lloyd's website which has information about sanctions on a country by country basis.

The Market Associations also provide guidance to their members.

Activity

Visit the Office of Foreign Assets Control (OFAC) website to find out more about US sanctions:

www.ustreas.gov/ofac

www.gov.uk/government/organisations/office-of-financial-sanctions-implementation

Question 7.2

Against which combination of parties can sanctions be imposed?

a. Individuals and companies ☐

b. Companies and governments ☐

c. Governments, individuals and companies ☐

d. Governments and individuals ☐

B5 Export controls

The UK Government issued an Export Control Order in 2008 (updated in 2015 with more items which fall into the categories below) which updated previously existing legislation and which requires that a licence is obtained:

- If there is movement of arms or other military goods between two overseas countries (i.e. not the UK).
- If there is the involvement of any UK person including those UK entities which might be involved only by insuring such goods.

There are various categories of licence, as shown in Table 7.1:

Table 7.1: Categories of licence (export controls)

Category	Includes
Category A	Gallows, guillotines and electric chairs.
Category B	Rocket launchers, other similar missile launchers being capable of operation by three or fewer people, and hand grenades.
Category C	Military goods which do not otherwise fall into Category A or B, tear gas equipment, pepper spray and PAVA spray which operates in the same way as CS Gas by causing pain and disabling people if sprayed into the eyes.

Category A goods require insurers to obtain a licence from the UK Government if they are being insured, but Categories B and C only require a licence if the insurance is being obtained for a journey to an embargoed country. This is not an area where late reporting and an apology will be acceptable. Trading (and that includes providing insurance) without a licence is a criminal offence and will result in fines and even imprisonment.

An embargo is a trade ban

An embargo is a trade ban, and as we have previously seen earlier in this chapter there are some countries to which trade is prohibited.

The list of embargoed countries under the ECO 2008 contains countries such as Burma, Iran and China.

Activity

Visit this website to find out more about Export Control:

www.bis.gov.uk/policies/export-control-organisation

See these websites for specific ECOs relating to Libya and Iran issued in 2011 and 2012 respectively:
www.legislation.gov.uk/uksi/2011/825/contents/made

www.legislation.gov.uk/uksi/2012/1243/contents/made

C Data protection

In this section, we will start to look at something else rather closer to home which is the subject of data protection. With the introduction of computers, the ability for organisations to maintain significant amounts of personal data about individuals increased dramatically and a need was identified to exercise some control over the way in which data was managed, and more importantly to prevent it being bought and sold freely as an asset.

Reinforce

Think about the websites you have used to register for or buy something. What data did you enter about yourself? Would you be happy if you found that the data was just passed on to other organisations without your permission?

The Data Protection Act 1984	Gave individuals the protection of the law should an organisation lose, disclose without authorisation, or retain inaccurate information about them. Information that was held in a form that made it possible to process it automatically, e.g. computer data, was defined as 'data' for the purposes of this Act.
The Data Protection Act 1998	Replaced the 1984 Act. It concerns the regulation of data transfer and it does not confine itself to computer data. Within its scope can fall other information about private individuals that is stored in other types of system. As long as the system is organised in a way that, broadly speaking, means the data can be interrogated by name, it falls within the scope of the Act.

Activity

Find your HR team and ask them how they ensure that employees' personal data remains secure and how they ensure that they comply with the provisions of the Data Protection Act.

C1 Definitions

Personal data is data that consists of information relating to a living individual who can be identified from that data, with or without other information that the Data Controller has in their possession.

Personal data is data that consists of information relating to a living individual who can be identified from that data

The Data Controller is a 'person' who either alone or jointly with others determines the purposes for, and the manner in which any personal data is being, or is to be processed.

All Data Controllers must be centrally registered with the Information Commissioner's Office (ICO). The ICO is the UK's independent authority set up to uphold information rights in the public interest, promoting openness by public bodies and data privacy for individuals.

Activity

Visit https://ico.org.uk/ to see how the ICO helps protect you as an individual.

Definition of the word 'person'

The word 'person' in law has a wider definition than 'human being' – it means an entity recognised in law (of which an individual human being is one form, another being a company). In many cases, the Data Controller is often in fact a company or other organisation (e.g. the police force).

The 'data subject' is the person whose data is being held.

Activity

If you had the same name as someone else in your company, what other information might be used to identify you?

The Act uses general terminology about the type of equipment that falls within its terms for non-manual data. If someone is unsure as to whether their equipment falls within the definition, they should take advice from the Registrar.

In the 1984 Act, personal data included both statements of fact and expressions of opinion about an individual. The 1998 Act expands this concept and specifically includes information held about the intentions the Data Controller has towards the individual.

Sensitive data means data about a person's:

- racial or ethnic origin;
- political opinions;
- religion;
- membership of a trade union;
- physical or mental condition;
- sexual life; and
- commission or alleged commission of an offence and issues linked to legal proceedings.

Stricter rules apply to the holding and transferring of such data.

C2 Data protection principles

Broadly speaking the Act has derived its terms from an EU Directive. The European Union **Data Protection Directive** (95/46/EC) was implemented in 1995. The Act puts in place eight principles to make sure that personal information is handled properly. We will examine each of the principles in turn:

- **Fair and lawful**. Personal data must be processed fairly and lawfully. In particular, processing must be either with the data subject's consent or necessary for a defined purpose. A defined purpose relates to one of the following:
  - the performance of or entering into a contract;
  - compliance with the legal obligations of the data controller (other than those assumed by contract);
  - the protection of the vital interests of the data subject (that might be you);
  - the administration of justice or the public interest; and
  - the legitimate interests of the data controller or others as long as they do not prejudice the rights, freedoms or legitimate interests of the data subject.

In the case of sensitive personal data more stringent conditions apply.

Consider this…

What if you were taken ill at the office? Say the HR manager accessed your data to tell the paramedics about a medical condition known to the company but which you preferred to keep private. Do you think this is OK for the protection of your vital interests?

- **Specified purposes**. Obtaining personal data has to be for one or more specified, lawful purpose. It cannot undergo further processing in a way that is incompatible with that purpose.
- **Not excessive**. Personal data shall be adequate, relevant and not excessive in relation to the purpose or purposes for which they are processed.
- **Accuracy**. Personal data shall be accurate and, when necessary, kept up-to-date.
- **Processing and keeping**. Personal data is not to be kept longer than is necessary to fulfil the purpose for which it is being processed.
- **Data subject's rights**. When personal data is processed it must be in accordance with the data subject's rights under the Act. Failing to do this would include not supplying information when properly requested or not complying with notice given under the provisions of the Act.

Personal data must not be vulnerable to unauthorised or unlawful processing

- **Protecting data**. Personal data must not be vulnerable to unauthorised or unlawful processing. Similarly, it should not be at risk of accidental loss, destruction or damage. Appropriate technical and organisational measures must be in place to ensure its protection against these risks. The Act gives guidance as to what the term 'appropriate' means. This guidance relates to the state of development of security measures, cost-effectiveness issues and the harm that could result from a breach of security. It also considers the reliability of the staff holding the data.

- **Data transfer**. Personal data can only be transferred to countries and territories within the European Economic Area (EEA). Transferring personal data beyond the EEA is only possible to countries or territories that offer adequate protection to the rights and freedoms of data subjects in relation to the processing of personal data.

  EEA comprises the countries of the EU plus Iceland, Liechtenstein and Norway.

Personal data can only be transferred to countries and territories within the European Economic Area (EEA)

Question 7.3

How is personal data defined in the Data Protection Act 1984?

a.	Information relating to a living individual who can be identified from that data	☐
b.	Information relating to any individual living or dead who can be identified by that data	☐
c.	Information relating to staff employed by a certain organisation only	☐
d.	Information held by everybody about themselves	☐

Data subjects' rights

The Act gives rights to individuals in respect of personal data held about them by others. The main rights are as follows:

- to have access to data held on them subject to the payment of a fee;
- to prevent data processing likely to cause damage or distress to them;
- to prevent data processing for the purposes of direct marketing;
- relating to automatic decision taking (which means avoiding automatic decisions made about things such as credit-worthiness based on incorrect data);
- to compensation if the individual suffers damage because of any contravention of the Act by a data controller;
- to apply to the court to enforce the rectifying, blocking, erasing or destroying of incorrect data; and
- to make a request to the Information Commissioner for an assessment to be made as to whether any provision of the Act has been contravened.

C3 How do insurers ensure that they comply with the Act?

Activity

List ten pieces of information that you would have to provide to a car or household insurer as part of a proposal.

Given the requirements of the Act, it is very important that insurers balance the following:

- the rights of the individual to ensure that their personal data is not misused; with
- the ability to share data about policyholders in an attempt to avoid fraud either in the purchasing of insurance or in the claims process.

The insurer must train its staff and ensure that its processes and procedures are set up in such a way as to minimise the danger of infringement of the Act.

Activity

Go to a 'price comparison site' (an aggregator) such as www.confused.com or www.moneysupermarket.com. Locate its privacy policy and review what steps it says it takes to protect your position. Look at the words and terms it uses and refresh on this section about their meaning.

The sharing of data within the insurance market is very important for the prevention of fraud and even with the provisions of the Data Protection Act 1998, certain amounts of data are put onto central market databases. Insurers should make this sharing of data completely transparent to you as the customer and the privacy policy on insurers' websites, or those of aggregators (marketed as price comparison sites) make clear what is happening to your data.

The sharing of data within the insurance market is very important for the prevention of fraud

Activity

Have you ever renewed your car tax disc online? If so, you will have noticed that the DVLA system automatically checks for valid insurance coverage and will not allow you to proceed if it cannot find it. If you haven't done so – ask your friends and colleagues.

How do you think this fits in with the Data Protection Act 1998? Have you (or your friends/colleagues) ever thought about it and been concerned about how the DVLA had access to this data?

C4 General Data Protection Regulation (GDPR)

Be aware

The **General Data Protection Regulation (GDPR)** will come into effect on 25 May 2018 and replace all existing data protection legislation, including the Data Protection Act 1998. This will occur regardless of decisions taken by the UK concerning membership of the EU.

The GDPR aims to ensure that the regulation of data is simplified and that gaps in existing legislation, such as those pertaining to electronic data, are addressed. Key components of the GDPR include:

- The right of individuals to have their personal data erased and to transfer it from one organisation to another (data portability).
- A mandatory requirement to report a breach within 72 hours of it becoming known, and to inform the individual concerned 'without undue delay', if their rights are likely to be at risk.
- The introduction of a statutory role of data protection officer (DPO).
- Tougher fines for non-compliance with the legislation.
- Application of the GDPR to companies outside the EU processing the personal data of EU citizens.

For further information, see: www.eugdpr.org/key-changes.html.

D Anti-money laundering

In this section we will look at the process by which funds which have been obtained illegally are made to look legitimate by 'laundering' through a financial system (which is not always insurance-based). In this case 'laundering' has nothing to do with washing but the analogy of making something clean is relevant to the process and end result.

D1 Definition

Money laundering is the process by which criminals attempt to disguise the origin of cash or other assets that they have earned from crime

Money laundering is the process by which criminals (including terrorists) attempt to disguise the origin of cash or other assets that they have earned from crime. They do this to avoid having the money or assets seized by the authorities and to keep them distanced from the original crime that generated the money. This does not apply only to large criminal syndicates but may be on a much smaller scale.

Money laundering has a particular relevance in the financial services sector. A criminal may choose to deposit their illegally obtained cash into an apparently legitimate arrangement, such as a pension, life policy, unit trust, building society account or into travellers' cheques. They may take out a general insurance policy and then cancel it shortly after so they can get the return premium. Criminals are happy to discount money (i.e. lose a small percentage as a penalty) if the result of the transaction is that it becomes 'clean' money.

Three stages of money laundering are placement, layering and integration

The traditional model used to describe money laundering comprises a three-stage process, as follows:

Placement	This is the process of putting cash into the financial system and converting it into other financial assets, such as cheques or even property.
Layering	It may still be possible to trace the money back to its illegal origins so the criminal will want to get involved in layering. Layering is where the criminal creates a series of complex transactions.
Integration	This is where the criminal finally gets access to the 'clean' money. There are many ways of giving the impression of a legitimate arrangement. The replacement of stock and its sale to the public is one example. Often much more sophisticated methods are used. Buying or leasing property or creating a company and drawing a salary are two more examples.

The three stages may occur as separate and distinct phases or they may overlap and it is unlikely that all three would occur at the same financial institution.

Question 7.4

What are the three distinct phases of the traditional money laundering model?

a. Placement, layering and flushing ☐
b. Placement, layering and integration ☐
c. Layering, integration and transacting ☐
d. Placement, integration and loading ☐

D2 Sources of law and regulation concerning money laundering

There are three strands to the rules that apply to money laundering:

- Specific laws that define what represents a criminal offence and the penalties that apply to such Acts (which are of general application).
- Money laundering regulations that apply to a stated range of firms operating in the financial services sector (but not necessarily specific to general insurance).
- FCA rules and guidance that apply in different ways to different categories of regulated firms.

D3 Money laundering legislation

The UK law relating to money laundering has developed and widened over time as follows:

The Criminal Justice Act 1988	created the criminal offence of money laundering, but only in respect of drug trafficking and terrorism.
The Criminal Justice Act 1993	made it a criminal offence to launder the proceeds of other serious crimes.

Consider this…

Do you think that the international nature of the London Market makes it more, or less, difficult to spot money laundering issues?

Proceeds of Crime Act 2002 (POCA) as amended – extended the range of offences for money laundering.

POCA established the current principal money laundering offences:

- **concealing, transferring, converting, or removing criminal property**. 'Concealing' would include hiding cash or valuables; 'transferring' would include sending a BACS transfer; 'converting' includes selling a stolen car for cash;
- **making arrangements in respect of criminal property.** This has a very wide definition and would, for example, include organising the sale of criminal property or setting up an account to receive the proceeds of crime; and
- **acquiring, using or possessing criminal property**. 'Acquiring' would include purchasing criminal property. 'Using' would include presenting criminal property as collateral for a loan. 'Possession' would include a bank holding the proceeds of crime in a client's bank account.

In addition, it established:

- offences of **failing to report suspected money laundering**; and
- offences of **tipping off about a money laundering disclosure** (a suspicious report) or investigation.

The 'principal money laundering offences' apply to everyone; the others apply only to persons who carry out regulated activity in the 'regulated sector', whether or not the specific FCA money laundering rules (see below) apply to those firms.

The 'principal money laundering offences' apply to everyone

An offence is committed if a person does the act described and at the same time has a guilty state of mind (i.e. if they know or suspect that the relevant acts involve criminal property).

Sanctions

The sanction is the same for each principal offence: a maximum prison sentence of 14 years, an unlimited fine, or both. The sanction for the other two types of offence (failing to report suspected money laundering and of tipping off about a money laundering disclosure or investigation) is a maximum prison sentence of five years, an unlimited fine, or both.

The offence of 'failing to report' is subject to an objective test of negligence, in other words a test of reasonableness.

?

Question 7.5

Imagine you are a claims handler. You are concerned about the fact that the claim funds appear to be being paid to an entity that is unconnected with the policy and is not otherwise involved in the claim.

If you ignore your suspicions and pay the funds, of which offence (aside from any principal money laundering offence), if any, might you be guilty under POCA?

a. Integration ☐
b. Tipping off ☐
c. None ☐
d. Failing to report ☐

POCA also set up an Assets Recovery Agency (ARA)

POCA also set up an Assets Recovery Agency (ARA) with financial investigators whose purpose was to recover the proceeds of criminal activity.

The **Serious Crime Act 2007 (SCA)** extended a range of serious crime prevention orders that could be made by the High Court and amended POCA in a number of important respects. It abolished the Assets Recovery Agency and transferred all its activities to the National Crime Agency (NCA).

D4 Money laundering regulations

The regulations, though they have been widened in scope, do not apply directly to general insurance companies or intermediaries (however, they do apply to life, pensions and investment activities).

D4A Money Laundering Regulations 1993

The Money Laundering Regulations 1993 are fundamental to money laundering prevention in the finance sector

These regulations are fundamental to money laundering prevention in the finance sector. They require the creation and maintenance of systems to prevent and control money laundering and effective training to be in place. The provisions apply to defined organisations operating in the UK financial sector, but not general insurance activities, including mediation activities.

D4B Money Laundering Regulations 2007

Further regulations were brought into force in 2003, but these have been repealed by the latest regulations effective from December 2007. These latest regulations supplement the provisions of the 1993 and 2003 regulations.

In summary, the new regulations cover a wider range of businesses. These are defined as:

- Credit and financial institutions including life companies and financial advisers.
- Auditors, accountants, tax advisers, estate agents, lawyers and other experts.

They cover the following areas:

- **Customer due diligence**. Verifying the identity of the customer (and the beneficial owner of the customer, if different) and obtaining information on the purpose and intended nature of the business relationship. If the customer is not present for the transaction further measures are required, such as the production of additional documents, confirmation of identity from an appropriate financial institution, or payment through a credit institution.
- **Policies and procedures**. These are to be risk-sensitive. The rules relate to due diligence measures, reporting, record-keeping, internal control, risk assessment and monitoring in order to prevent activities related to money laundering and terrorist financing.
- **Registration**. Organisations must register and there are detailed procedures for this as well as a list of reasons for the Authority to refuse registration.

Enforcement powers include the right to enter and inspect premises and take copies of any relevant documents

- **Enforcement**. Enforcement powers include the right to enter and inspect premises and take copies of any relevant documents. Designated authorities can impose appropriate civil penalties. 'Appropriate' is defined as being effective, proportionate and dissuasive. If partners or directors are personally responsible for failure to comply with regulations they may be fined or imprisoned for up to two years, or both. In this case they would not also be liable to a civil penalty as they are being punished in accordance with the criminal penalties in the regulations which are in a different section of the rules.

D5 Regulatory rules and guidance on financial crime

The Financial Conduct Authority gives high priority to the protection of consumers as potential victims of financial crime, as well as the use of firms as the conduit for financial crime.

Activity

Given what you have just learned about anti-money laundering, think about practical steps that companies can take to prevent possible problems. Think about education, procedures and systems solutions.

'Financial crime' was defined in the FSMA as fraud, dishonesty, misconduct in, or misuse of information relating to, a financial market or handling the proceeds of crime. The FCA concentrates on identifying current and emerging financial crime threats and on ensuring that the awareness of their implications and how to mitigate them is embedded across the operations. The aim is that firms maintain and where necessary enhance their own systems and controls against financial crime. The FCA is using thematic reviews involving detailed testing as to whether firms are meeting their legal and regulatory obligations.

The FCA can impose penalties for market abuse and undertake criminal prosecutions for insider dealing and market manipulation.

Joint Money Laundering Steering Group (JMLSG)

The JMLSG is made up of the leading UK Trade Associations in the financial services industry. Its aim is to promote good practice in countering money laundering and to give practical assistance in interpreting the UK Money Laundering Regulations. This is primarily achieved through the publication of industry guidance which is then used by the FCA in consideration of whether breaches have happened within the financial services industry.

This group includes organisations such as the Association of British Insurers, the British Bankers Association and the Council of Mortgage Lenders.

Many insurers and brokers will have considered these standards in order to establish their own procedures in support of their general duty to meet regulatory requirements.

Regulatory rules insist that firms must have in place systems and controls, which must include giving their employees suitable training, with regard to money laundering. The governing body and senior management must be in receipt of certain information and the firm's appointed Money Laundering Reporting Officer (MLRO) must make a report at least annually on how the systems and controls operate and on their effectiveness.

Activity

Look at the JMLSG website and find out more about its role and the guidance it issues to the market:

www.jmlsg.org.uk

The firm also needs to document both its risk profile and risk management policies in relation to money laundering. On a day-to-day basis it must take the risk of money laundering into account when developing new products, taking on new customers and when changing its business profile.

A director or senior manager who may also be the MLRO must take overall responsibility for establishing and maintaining effective anti-money laundering systems and controls within the firm.

Note the following about the MLRO:

- Takes responsibility for the firm's compliance with the FCA rules relating to money laundering.
- Acts as focal point for all anti-money laundering activity in the firm.
- Expected to be UK-based.
- Required to have certain levels of authority and independence within the firm.
- Required to have sufficient resources and information to enable them to fulfil their responsibilities.

Anyone who suspects that money laundering is taking place must report this to the MLRO. The MLRO must then decide whether the suspicious transaction should be reported to the National Crime Agency (NCA). As you saw earlier, failure to report knowledge or a suspicion of money laundering is a criminal offence. Reporting to your MLRO discharges your legal responsibilities.

Anyone who suspects that money laundering is taking place must report this to the MLRO

D6 Protection measures

To aid the detection of money laundering it is important to protect the person who reports their suspicions. The NCA must know their identity as they may need to obtain further information from them in pursuing their investigations. Outside the investigation, however, their names will be concealed and they will not be called upon to give evidence.

Reinforce

Do you remember how whistle-blowers are protected? If not, revisit chapter 6, section B7.

D7 Client verification

Firms must take all practical measures to check the identity of new clients

Firms must take all practical measures to check the identity of new clients. This includes ensuring that their address details are genuine. Money laundering regulations are not specific as to the precise nature of appropriate means of identification. However, guidelines issued by JMLSG state that client verification for individuals should be 'photographic'. They will be among the following:

- A valid passport.
- Valid photo card driving licence.
- National identity card for non-UK nationals.
- Firearms or shotgun certificate.
- Identity card issued in Northern Ireland.

In the absence of one of these types of identification, then a document which does not have a photograph (such as an old-style UK driving licence) may be used but must be supported by a further document such as a recent utility bill showing the client's current address.

A home visit to the client is suitable evidence, provided that it is clear that the house genuinely is the personal residence of the client and this is only one of two means of identification.

A client's bank or another reputable financial institution can be asked to verify their identity where they are not being met face-to-face.

Identification requirements for a company

In the case of a company, it is necessary to establish:

- its full name;
- registered number;
- registered office in the country of incorporation; and
- business address and to check that it legally exists for normal business operations. This could be done by, for example, obtaining a copy of its Certification of Incorporation or searching the relevant company registry. Any complex ownership arrangements should be clarified.

Any complex ownership arrangements should be clarified

Proof of identity should be obtained as soon as possible and transactions should not be completed until it has been provided. Any verification difficulties should usually be reported to the MLRO and, possibly, by the MLRO to the authorities.

Records must be kept for five years.

Activity

Think about how this works in a commercial insurance situation which includes an insurer, broker and client. Does the insurer have to confirm all the details independently or can it rely on the broker verifying their client's identity?

Ask your colleagues what they think. Try to find out what happens in your company.

D8 Summary of money laundering rules

General insurers and intermediaries are subject to the regulators' high-level rules, which contain specific requirements regarding anti-money laundering measures. Their employees are also individually subject to the terms of CJA and POCA.

Therefore, although general insurers and intermediaries are not directly impacted by the Money Laundering Regulations, they are required to comply with the regulators' specific money laundering rules. Firms must follow guidance issued by the JMLSG in relation to client verification, and appropriate systems and controls.

E Bribery

In this final section we are going to consider an area which has become very much in focus recently.

Another word which should be used for 'bribery' is 'corruption' which gives an indication of the seriousness with which this issue should be treated.

The **Bribery Act 2010** which is a piece of UK legislation, came into force on 1 July 2011 and within it there are four major offences which are:

- bribing another;
- being bribed;
- bribing a foreign public official; and
- failure to prevent bribery.

The first two are not new offences as one of the things that the Bribery Act 2010 is meant to do is harmonise pre-existing legislation on the topic, however the last two offences are new.

The last offence listed is a corporate offence and companies are at risk if they do not put in place systems and controls to counter this risk. Suggested systems and controls include:

- There should be an anti-corruption culture in the organisation, led by its directors.
- There should be a named senior individual responsible for anti-corruption procedures in the organisation.
- Risk assessments should be in place to determine the potential risk of bribery occurring.
- Organisations should have a clear code of conduct that addresses anti-corruption issues.
- Penalties for participating in corrupt activities should be clearly spelt out in employees' contracts of employment.
- Organisations should have a procedure relating to gifts and hospitality that sets out what is and what is not acceptable and ensures that corruption does not occur.
- Employees should be given training in anti-corruption matters.
- Such financial controls should be in place that the possibility of corruption is made unlikely.
- Such whistle-blowing procedures should be in place that employees could report any matters relating to corruption without fear of retaliation.

Given that a large London Market broker received a record fine for a bribery offence in 2011, this is obviously something that all market participants need to be very mindful of, and in certain cases money laundering and bribery issues will arise with the same activities.

Activity

Review the FSA report on the fine mentioned above:

www.fsa.gov.uk/pages/Library/Communication/PR/2011/066.shtml

There is also US legislation (**Foreign and Corrupt Practices Act 1977**) which prohibits bribery of foreign government or political officials. Given that some London Market insurers and intermediaries have ties with US entities, it is important for them to be mindful of this US legislation in the same way as they must be mindful of the US sanctions discussed earlier in this chapter.

Activity

Speak to your firm's Compliance Officer and ask them what actions they are taking to ensure compliance with this legislation. Have you had any specific training on the subject?

Review the Ministry of Justice guidance on the Bribery Act to see if corporate hospitality is impacted:

www.justice.gov.uk/guidance/docs/bribery-act-2010-guidance.pdf

Key points

The main ideas covered by this chapter can be summarised as follows:

Impact of UK, EU and US regulation

- A significant amount of London Market business comes from outside the UK.

Sanctions

- The UK Government together with the European Union and the United Nations imposes bans on dealing with certain governments, regimes, individuals and organisations called sanctions.
- The US Government also imposes sanctions which impact on insurers operating in the London Market, particularly if they have US corporate parentage.

Data protection

- Data protection is an important area of business and there are clear rules to ensure the safety and accuracy of any personal data held by companies.
- Personal data is defined as that by which an individual can be identified.

Anti-money laundering

- Money laundering is converting illegal funds into legal funds through transactions. Payment of premium using illegal funds and then requesting a return premium is a good example of such activity.

Bribery

- Bribery includes bribing others, being bribed, bribing a foreign public official and failing to prevent bribery.

Question answers

7.1 The correct answer is a.

7.2 The correct answer is c.

7.3 The correct answer is a.

7.4 The correct answer is b.

7.5 The correct answer is d.

Self-test questions

1.	List three different types of information about a risk in which an overseas regulator might be interested.
2.	What is meant by systems and controls within a business?
3.	Briefly explain what is meant by the term ‘sanctions’ and list the two main types.
4.	What is OFAC and what influence does it have on the London Market?
5.	Why are Cuban risks of interest to London Market insurers?
6.	What is meant by the term ‘personal data’?
7.	List four of the eight principles of data protection.
8.	What are the three stages in money laundering?
9.	What behaviour during a claim might make you suspect money laundering?
10.	What are the four offences under the Bribery Act 2010?

You will find the answers at the back of the book

8

Role of a broker

Contents	Syllabus learning outcomes
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Answers	
Self-test questions	

Learning objectives

After studying this chapter, you should be able to:

- explain the role and responsibilities of brokers/intermediaries;
- explain how intermediaries are authorised and supervised;
- explain the business role of broking and the parties involved; and
- explain the broker's role in the placing and claims processes.

Introduction

In this chapter we will be reviewing the role and importance of intermediaries – better known as brokers – in the insurance process and in the London Insurance Market. We will be exploring their relationship in law with both the insurers and the insured – and their responsibilities coming out of those relationships. We will also look at where they fit in the market processes for both placing and claims.

Key terms

This chapter features explanations of the following terms:

Accounting and settlement	Actual authority	Agency by consent	Agency by necessity
Agency by ratification	Agent	Apparent (ostensible) authority	Appointed representatives
Authorised persons	Binding the risk	Broker Insurance Document (BID)	Delegated authority
Express authority	Implied authority	Intermediary	Law of agency
Lloyd's insurance brokers	London Premium Advice Notes (LPANs)	Market Reform Contract (MRC)	Principal
Retail broker	Termination of agency	Terms of Business Agreement (TOBA)	Undisclosed principal
Unique Market Reference (UMR)	Wholesale broker		

A Legal basis of the broker's role

In this section we will look in more detail at the role of a broker, and for whom they perform this role. We will draw some distinctions with other types of intermediaries that may become involved in different classes of business.

A1 Who are the parties in the insurance transaction?

The most straightforward insurance transaction involves just two parties: the buyer of insurance (or the insured) and the seller of the insurance (the insurer).

The most straightforward insurance transaction involves just two parties: the buyer of insurance (or the insured) and the seller of the insurance (the insurer)

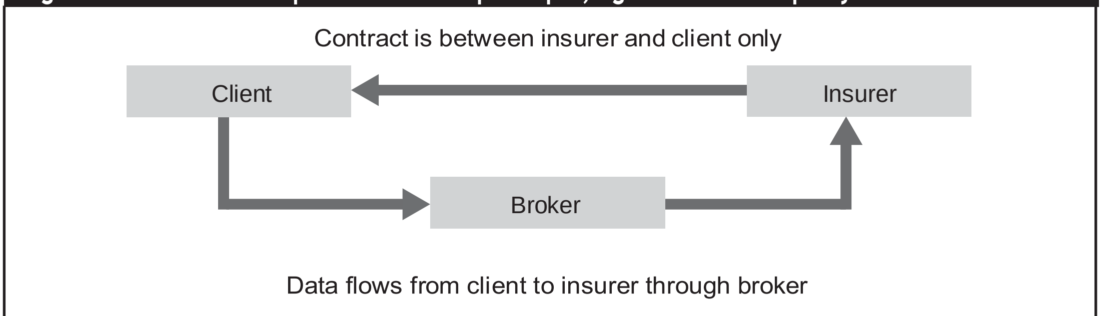
However, the buyer of insurance may not be knowledgeable about the options available to them either in terms of product or market and so will seek help from an expert adviser. This adviser is a broker, who is able to offer independent impartial advice concerning available products and markets and can represent the insured in communications and negotiations with any potential insurers.

A2 Principal and agent

In legal terms an 'agent' is one who is authorised by one party – termed the 'principal' – to bring that principal into a contractual relationship with another – termed the 'third party'. Here, the client is the principal, the broker is the agent and the insurer is the third party.

Figure 8.1 depicts the relationships described:

Figure 8.1: Relationship between the principal, agent and third party



There are other types of intermediaries who act as agents for **insurers** in that they are only permitted to promote and provide certain insurer products to their customers. These types of intermediaries are not generally encountered in the commercial business handled in the London Market but are heavily involved in more personal lines products such as household, motor and pet insurance. They will be covered in more detail in study text *LM2: London Market insurance principles and practices*.

Activity

Talk to your friends or colleagues about their personal insurances (e.g. home, car or travel). Did any of them use a broker, and if they did, can they explain why?

Record their reasons and consider them as you review the rest of this chapter.

A3 Law of agency

In law, everyone who acts on behalf of another person is an agent. If we allow someone to act for us, or even if we allow them to say that they are acting for us without denying the fact, we will probably have to accept responsibility for whatever actions they undertake on our behalf.

In law, everyone who acts on behalf of another person is an agent

A3A Methods of creating an agent/principal relationship

There are three ways in which the relationship of principal and agent can

- consent
- necessity
- ratification

Agency by consent

The most usual way of creating a relationship between principal and agent is by consent, also known as an agency by agreement. Both parties enter into a legally enforceable agreement. This is usually by means of **express appointment** where the terms of the appointment are written down. It is by far the most common method used in insurance. The documents used in the London Market are called **Terms of Business Agreements (TOBAs)**. These are put in place between any brokers and their clients as well as (perhaps unexpectedly) between brokers and the insurers with which they are placing business.

TOBAs are studied in more detail in study text *LM2* but it is important to understand that their key role is to set out clearly each party's rights and responsibilities regarding the relationship into which they have entered.

It is also possible for an agency relationship to be created by consent in an **implied** way. This could be the case where work is undertaken and a commission paid but no agreement is written down.

Agency by necessity

This arises where a person is entrusted with someone else's goods and it becomes necessary to act in a certain way in order to preserve the property in an emergency.

Example 8.1

An example of this would be where you were looking after your friend's furniture for a short time whilst they were moving house.

You suffered an accidental fire in the building where the furniture is being stored and in order to save the furniture you pour significant amounts of water onto it, which causes some damage to seat coverings but prevents far worse damage by fire.

In this situation you would not have time to call your friend to ask their permission to pour water on their furniture, making you an agent by necessity.

Agency by ratification

Ratification refers to a situation where an agent acts without authority, but the principal accepts the act as having been done by the agent on their behalf. The principal's **agreement after the event** is their ratification and they are bound by the contract to the third party. Where this occurs the principal must ratify the whole contract and is not able to vary its terms or pick and choose which elements to accept. This could occur where the agent has no authority at all or is acting outside the terms of an agency agreement.

Ratification is the act by which the principal agrees the actions of the agent after the event, basically making them acceptable retrospectively within the terms of the agency agreement, although they were not when they were actually performed.

Example 8.2

An agent has authority to buy vegetables for their principal, but one day they come back from the shops with not only vegetables but also meat and chocolate. The agent has acted outside their contract as they don't have the authority to buy meat and chocolate for their principal.

Their principal could refuse to accept both the meat and the chocolate as it was bought without their authority. If the principal decides to ratify their agent's actions, they must accept both the meat and the chocolate, they cannot pick and choose.

Question 8.1

A broker is advised by the insurer that one of the terms of their client's policy needs to be amended. They agree to this but do not tell their client. When their client finds out, they are agreeable to the change made.

What type of agency does this create?

a. Agency by requirement ☐
b. Agency by necessity ☐
c. Agency by ratification ☐
d. Agency by default ☐

Activity

If you work for a broker, find out how you obtain instructions from your clients. Are they always absolutely clear?

A3B Relationship of agent to principal

In most cases, an agent represents only one of the contracting parties

In most cases, an agent represents only one of the contracting parties. In some unusual cases where the broker has been granted some authority by the insurer (for example claims settlement authority up to a certain level), then they are acting for both the client and the insurer and they must be careful to avoid any 'conflict of interest' between them.

Activity

What practical steps can a broker take to ensure that conflicts of interest are minimised if it has claims settlement authority from an insurer?

A3C Agent of the insured

An independent intermediary is considered to be the agent of the insured when the intermediary gives advice:

- on cover or the placing of the insurance; or
- to the insured as to how to make the claim.

A3D Agent of the insurer

An independent intermediary is considered to be the agent of the insurer when the intermediary:

- can bind cover, i.e. has the authority of the insurer to accept risks as if they were the insurer themselves; and/or
- has authority to collect premiums and does so.

A4 Duties of an agent

An agent has the following duties to their principal:

An agent has duties of obedience, personal performance, due care and skill, good faith and accountability

- **Obedience**. One of the prime duties owed by an agent to their principal is the duty to obey instructions. If the agent fails to comply, they are liable to be sued by their principal for damages.
- **Personal performance**. As a general rule, an agent must perform the duties imposed on them by the agency. The special nature of the relationship between principal and agent means that they cannot delegate their duties to someone else (although purely mechanical tasks may be delegated). In practice, an agent for the placing of an insurance risk is a company. The particular individual who meets with the client is not expected to carry out all the negotiating and placing functions: it is often market practice for these tasks to be given to specialists in the company.
- **Due care and skill**. A person must exercise due care and skill in the performance of all acts done in the course of their duty as an agent. An independent intermediary is a person who claims to be a specialist in insurance and must, therefore, offer a higher standard of ability than someone whose main profession is not insurance.
- **Good faith**. An agent's relationship with their principal is one of trust. It follows that they must not allow their own interest to conflict with their duties towards their principal. Agents must not accept bribes or secret commissions.

Activity

Search for the term 'contingent commission' on the internet and read about the issues that have been caused by such commissions in the market.

- **Accountability**. An agent must account to their principal for all money they receive on their behalf, and must keep a proper record of all transactions.

A5 Duties of a principal

A principal has the following duties to their agent:

The agent has a right to the remuneration agreed by their principal

- **Remuneration**. The agent has a right to the remuneration agreed by their principal or, if none has been fixed, to a reasonable remuneration as is customary or appropriate. For insurance transactions the remuneration usually consists of commission, and to earn this the agent must prove that they were the effective cause of any transaction. Essentially, an agent has not 'earned' their commission until a contract has been signed.

  Where an intermediary/broker has provided some additional services such as risk management advice then a fee may be chargeable to the client.

  In the case of insurance, it is customary for the insurer to pay a commission to intermediaries known as brokerage. The level of this commission need only be disclosed to a commercial client when requested by them; however, it must always be disclosed to a consumer client.

  Note that intermediaries, with the need to be transparent in their dealings, have also started to disclose such commission to commercial clients.

Reinforce

Do you remember that the regulator (FCA) distinguishes between commercial clients and consumers? To refresh your knowledge, refer back to chapter 6, section B5.

- **Indemnity**. Subject to any express terms in the agency agreement, an agent has a right to claim from their principal an indemnity against all expenses or loss incurred when acting on the principal's behalf.

A6 Undisclosed principal

English law permits an agent to act for an undisclosed principal, whilst seeming to act on their own behalf

In most situations it is clear that an agent is acting not on their own behalf, but as an agent acting on behalf of a principal. English law permits an agent to act for an undisclosed principal, whilst seeming to act on their own behalf. The agent must have authority to act on behalf of the undisclosed principal at the time the contract is made for it to be effective. In other words, the terms of the agency agreement must be clear between the principal and agent.

In reality, in the London Market, given the importance to the consideration of the risk of knowing the identity of the insured, the 'undisclosed principal' will rarely be encountered. Whilst clients may appear to be 'hazy' by using companies to own assets which in reality are owned by a multi-millionaire who likes their privacy, it is usually clear that the broker is merely the intermediary.

A7 Consequences of an agent's actions

The consequences of an agent's actions on the principal depend on the particular circumstances. Influential factors will be the extent of the agent's authority: whether there is actual authority, apparent authority or no authority.

A7A Actual authority

Actual authority may be express or implied, as follows:

Express authority arises from the terms of an agency agreement, which may be oral or in writing

Express authority arises from the terms of an agency agreement, which may be oral or in writing. As already indicated, it would be unusual for this to be oral in an insurance context; all terms would be expressed in a TOBA.

Implied authority may be one of two kinds. If the agent has to undertake a certain action in order to carry out express instructions, they will have implied authority to do so. So, for example, if an agent needs to travel to a particular place to carry out the principal's instructions, the travel costs will be met without any need to have specific agreement on this aspect. On occasions, there is an authority that is usual for the particular situation or business arrangement. This situation may result in problems in an insurance context should an agent act outside the express terms of appointment. We shall consider this next.

A7B Apparent (ostensible) authority

It is unlikely that a third party will be aware of the extent of an agent's authority

It is unlikely that a third party will be aware of the extent of an agent's authority. Since the third party is often in no position to make any judgment about the extent of such authority, the situation is catered for in law by what is termed 'apparent' authority. There are different situations in which it may arise in an insurance context.

Ostensible authority is that which should come with a certain position in an organisation – for example a Chief Executive Officer (CEO) should have more authority than someone who is not on the board.

eg

Example 8.3

A good example is where a broker has been granted some delegated authority from an insurer. That authority permits them to bind risks on the insurer's behalf but may be limited to certain types of business such as property insurance.

Any client dealing with the broker is not going to know (or even think to ask) the nature and extent of the broker's authority; therefore, the broker might exhibit apparent authority, i.e. the ability to bind liability insurance business, whereas in reality their actual authority was just for property insurance business. Should they bind such a risk, the principal may well have to ratify the contract with the end client.

Here, the principal (insurer) ratifies the contract by subsequently accepting the actions of the agent (broker), which were outside the agency agreement when they were actually performed.

It is important that you recognise that even if the actions of an agent bind the principal to the contract – if the agent is acting outside their authority, the agent is liable to the principal for the agent's actions.

Even if the principal decides for reasons of reputation/brand protection to ratify the contract they still have the ability to pursue the agent for damages behind the scenes.

?

Question 8.2

A broker has been asked by their client to obtain some property insurance for them. If the broker approaches an underwriter with a request for some liability insurance for the same client, what type of authority are they using?

a. Practical ☐
b. Real ☐
c. Apparent ☐
d. Normal ☐

A8 Termination of agency

An agency may be terminated in a number of ways – the most common being:

- mutual agreement;
- termination by one party or the other; or
- death, bankruptcy or insanity of any of the parties.

Consider this…
Why might a client want to change brokers? Who does the broker need to notify if a client terminates their relationship?

It is important that all relevant parties are notified by the principal when an agency is terminated. The rule of apparent authority can apply for some time after termination and unscrupulous former agents may continue to commit their principal to further agreements. Insurers may find themselves bound to contracts entered into by an agent who no longer has any authority to act on their behalf.

B Regulation

Insurance intermediaries are authorised and regulated by the Financial Conduct Authority.

Regulation is also covered in chapter 6

The rules that relate to intermediaries (brokers) also apply to insurers in connection with their mediation activities, i.e. their advice, promotion and sales functions. In this section we will also look at the impact that Lloyd's has on the regulation and registration of brokers working in the London Market.

B1 Authorised persons

An intermediary wishing to offer independent advice must apply for direct authorisation by the FCA. Once authorised, a firm is bound to abide by all FCA rules. These rules are demanding, particularly in terms of financial accounting, training and competence and reporting requirements.

Consequently, since their introduction there has been a great deal of consolidation in the marketplace through sales and acquisitions of smaller firms of brokers. In addition, umbrella organisations have been created that are known as 'broker networks'. These vary in their structure, but one model for this is that the umbrella organisation becomes the authorised person and each 'member' (the broker) of the network becomes an Appointed Representative, thus availing itself of the centralised facilities and associated costs.

There has been a great deal of consolidation in the marketplace through sales and acquisitions of smaller firms of brokers

The FCA takes the position that its own rules are in addition to any legal duty of trust that an agent owes to a principal.

B2 Appointed representatives

An appointed representative may be an individual or a company that is appointed by an authorised person under the terms of a contract. An appointed representative may be acting for an intermediary that is itself directly authorised by the regulator.

An appointed representative may be acting for an intermediary that is itself directly authorised by the regulator

The TOBA determines the appointed representative's role and responsibilities. The key feature is that the principal takes responsibility for the appointed representative's activities in carrying on the business of the principal.

B3 Lloyd's insurance brokers

It is worth pointing out at this stage that the term 'broker' is frequently used in the insurance market. At one time it was necessary to be formally registered to use this term. Nowadays, in practice it tends to be only those offering truly independent advice that use the term in their title.

Although the term 'broker' may be freely used in the market, it is the Council of Lloyd's that registers insurance broking firms to act as Lloyd's brokers. This title and distinction from non-Lloyd's brokers still exists, even though access to Lloyd's has been granted to a wider range of intermediaries by virtue of **Legislative Reform (Lloyd's) Order 2008**.

To be registered, brokers must satisfy the Council as to their expertise, integrity and financial standing. Once appointed the words 'and at Lloyd's' may be used on the firm's letterheads and name plates. The requirements of Lloyd's are in addition to those of the FCA for authorised persons. However, Lloyd's no longer has its own separate code of conduct for Lloyd's brokers, relying instead on the regulator's rules for authorised persons.

Consider this…

Given that it is no longer a requirement to be a Lloyd's broker to work in Lloyd's, what are the benefits of being a Lloyd's broker? Ask senior colleagues what they think. Is it a branding issue?

B4 Wholesale and retail brokers

Although non-Lloyd's brokers are now allowed to access the Lloyd's Market, in the wider London Market, there is often a chain of brokers between the insurer and the ultimate client. This is often to do with the geographical spread of business coming into the market. Here, the client contacts a broker in their own region, the broker knows that the London Market is the best option for the client and therefore links up with another broker to access that market.

The broker with the direct contact with the client is known as the retail broker and their colleague who has the contact with the insurer is known as the wholesale broker

The broker with the direct contact with the client is known as the **retail broker** and their colleague who has the contact with the insurer is known as the **wholesale broker**. It is possible for these roles to be performed by two offices of the same broking firm.

B5 Regulation of intermediaries

Once authorised, an intermediary will be supervised in an ongoing manner by the FCA

Once authorised, an intermediary will be supervised in an ongoing manner by the FCA. The FCA has operational objectives and it assesses the risk to those objectives presented by any authorised firm. The higher the perceived risk, the closer the supervisory relationship that the FCA has with the firm concerned.

Should an intermediary fail to comply with FCA rules, then the FCA can take action under the Financial Services Act 2012. It can:

- withdraw that firm's authorisation;
- discipline both individuals and firms;
- impose penalties;
- apply to the court for injunctions (a court order requiring certain action to be stopped); and
- prosecute.

These controls and powers are exactly the same as those which the FCA can apply to an insurer that it authorises.

Activity

If you work for an intermediary, ask your compliance officer what supervisory contact your employer has had with the FCA.

C Services provided by intermediaries

In the London Market, the main distinguishing feature of an independent intermediary (which includes Lloyd's brokers) is the fact that the intermediary is acting on behalf of the client when placing business, not on behalf of the insurer in introducing the business. The expertise of the independent intermediary is, in part, demonstrated by making a recommendation as to the most appropriate insurer with which to place the risk.

C1 Services provided to clients

The intermediary must be capable of offering advice on the basis of a fair analysis of the market. It is important to remember that the available market is not always London. This does not mean that they do so in every case. However, there is an obligation under the regulatory rules to make available a list of product providers, if the market has not been fully explored and only a restricted number of insurers approached.

Perhaps surprisingly, the broker also acting as the agent for the insured is usually paid by the insurer as well. This payment, already mentioned in section A, is known as **brokerage** and is traditionally a percentage of the premium payable. Increasingly however, there is a tendency for intermediaries to charge clients a fee for their services instead (in which case they would rebate to the client the brokerage received from the insurer or agree a net premium with the insurer).

The broker also acting as the agent for the insured is usually paid by the insurer as well

The services that intermediaries provide for their clients vary considerably. If we consider independent intermediaries (such as London Market brokers) first, they will all carry out the following functions:

The services that intermediaries provide for their clients vary considerably

- review the client's needs;
- advise whether the risk is insurable;
- decide the best market for the risk;
- negotiate terms and conditions;
- provide advice to the client (for example, concerning the wording of the policy);
- negotiate renewals; and
- advise and assist clients in relation to claims matters.

There are further services that may be provided and these will be specified in the TOBA agreed with the client. They include such things as:

- risk management advice; and
- recoveries.

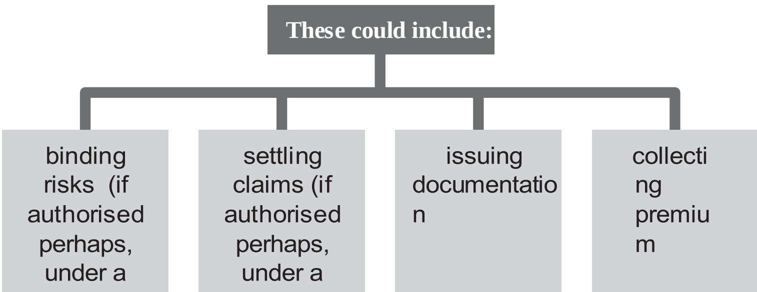
Reinforce

'Recoveries' means the same as subrogation – refer back to chapter 2 for the principles involved with this.

'Recoveries' tends to be the term used in the marine market and subrogation in the non-marine market.

C2 Services provided to insurers

So far, we have considered the services provided to clients. Other functions may be carried out by the intermediary on behalf of insurers, depending upon the TOBA with the insurer.



C3 Schemes and delegated authority

Many insurers have delegated some authority to intermediaries to act on their behalf.

Many insurers have delegated some authority to intermediaries to act on their behalf

Some delegated authority schemes (often called 'binders') give a great deal of flexibility to the intermediary within defined limits. Often the policy wording is specially negotiated to fit a particular category of client, e.g. haulage contractors, warehouse-keepers and hoteliers. The attraction of these schemes for an insurer is a flow of business arising from the tailored wording. There may also be an agreement on rating, but many schemes rely upon individual rates being provided by the insurer upon receipt of proposal information. Advantages for the intermediary are:

- the ability to grant immediate cover;
- ease of operation; and
- (quite often) some kind of profit-sharing provision, if the results of the scheme are good.

D Broker's role in the placing process

In this section we will review the practical role of the broker in the placing process, overlaying the theory reviewed earlier in this chapter.

D1 Initial enquiry from the client

On receipt of the initial enquiry from the client, the broker should be reviewing the client's requirements with them and considering the options, in terms of available markets and potential types of insurance. Whilst this syllabus and study text are focused on the London Market, it is important to appreciate that there are insurance markets worldwide. A good broker (particularly for commercial risks) should never just consider their 'home market' as the only option – as that may not be the best option for the client. Having decided that the London Market is a viable option to investigate for this client, the broker can move onto the next step in the process.

D2 Presentation of the client's risk to insurers

The broker puts together a summary of the risk into a document which is still colloquially called a 'slip', although its proper name is now the Market Reform Contract (MRC). This sets out the key information in a standardised form for presentation to insurers, but can be supplemented with additional material relevant to the risk in question – for example, proposal forms (although these are only used in certain types of commercial insurance) and survey reports.

Reinforce

How much can you remember about the obligation under the **Insurance Act 2015** to make a fair presentation and the need for full and frank disclosure of the risk being presented? If you need to refresh your knowledge, refer back to chapter 2, section D.

It is important that brokers remember that their knowledge is imputed on their client under the Insurance Act as knowledge that the insurer is deemed to have and should, if material, share with the holders.

Information known by the broker is considered to be known by their client

Under the Insurance Act, information known by the broker is also considered to be known by their client, unless it is confidential information that the broker has obtained from another source.

Consider this…

What do you think the broker should do in this scenario? Always double check with their client what information they have?

D3 Which insurers to visit?

One of the key benefits of using a broker is that they know the market and the insurers within it

One of the key benefits of using a broker is that they know the market and the insurers within it. In the next chapter we will review in more detail the concept of a 'subscription market' where more than one insurer takes a share in the same risk, but the key for the broker is to know the right combination of people to see to obtain cover for their client's risk. There are no market rules banning brokers from approaching a combination of Lloyd's and company market insurers, or mixing providers in the London Market and overseas market. It is entirely down to the broker's skill and knowledge to ensure that they obtain the best terms and conditions for their client – and of course that they use insurers that are going to still be in business when a claim needs to be paid.

The broker must take care to ensure that the insurers with which the risk is being placed are robust and will be around in the future

This final statement is possibly one of the most important. The broker must take care to ensure that the insurers with which the risk is being placed are robust and will be around in the future. Whilst there are various compensation schemes, the primary responsibility for using secure markets is the broker's. All brokers (even the smallest of firms) have committees or at the very least a senior individual who will be constantly reviewing the insurers' financial stability and they will not use those that they feel are not stable enough. This concept of security rating is covered in more detail in study text *LM2*.

Compensation schemes are covered in chapter 6, section F

D4 Quotations

In the same way as you would get a number of quotations for your own personal insurance, a broker should obtain a number of quotations for their client's business. These may vary not only in terms of price but also in the coverage being offered and the market involved; therefore, the broker needs to spend time explaining the differences to the client so that an informed decision can be made as to which of them to accept, or whether in fact to reject them all.

Once the client has decided which option to go for the broker can commence the process of finally binding the risk.

D5 Binding the risk

Here, the broker revisits the insurers which provided the quote that was accepted and asks them to confirm or 'ink' their line on the slip. Although the term 'inking' refers to the traditional way of stamping and scratching (or initialling) a paper slip, in today's market it is quite normal to have risks bound electronically.

Whichever way it is done, this final confirmation creates the contract between each insurer and the client.

Question 8.3

?

If a client is using a Lloyd's broker, which markets can be used for the placement?

a. Just Lloyd's ☐
b. Only the London Market ☐
c. Only the London and European markets ☐
d. Any market without restriction ☐

D6 Central recording of the risk and payment of premium

When the broker revisits all the insurers again to get their 'inked' line, each of the insurers takes a copy of the slip for its own records and enters some of the data in their computer systems.

The broker submits information about the risk to a company called Xchanging Ins-sure Services (XIS). This organisation manages the central market databases for risk data for both Lloyd's and IUA companies, and also facilitates the movement of premium funds centrally from brokers' bank accounts to the various insurers' bank accounts.

The information that has to be submitted to XIS (often just called 'the Bureau'), includes the slip and information about the premium to be paid, together with any taxes or similar sums that have to be accounted for. Documents called **London Premium Advice Notes** (LPANs) are generally used to present the premium information in a standard format.

Documents called London Premium Advice Notes (LPANs) are generally used to present the premium information in a standard format

Historically, presentation to XIS was done by depositing a set of papers with them which would be reviewed and returned, but now the system is becoming more electronic and a system called **Accounting and Settlement** is used for the vast majority of the risk and premium submissions by brokers, which involves a combination of scanned documents and electronic messaging.

Whichever way the data is submitted by brokers to XIS, the end product is still the same. The key data relating to the risk, including the identity of the brokers and the insurers, together with the amount of the premium and any brokerage is recorded on the XIS computer systems. Each night, every insurer is sent electronic messages advising them of the data recorded that day on risks in which they participate.

The broker gives the risk a unique code, called a **Unique Market Reference** (UMR). This code is recorded and reported to insurers, along with the other information captured and additional reference numbers relating to the transaction on the XIS system.

The broker gives the risk a unique code, called a Unique Market Reference (UMR)

It is very unusual, however, for the broker to pay the premiums for the risk directly to the insurers as the London Market has for many years, used centralised money movement systems.

The system facilitates the movement of funds out of the broker's bank accounts directly into the insurers' accounts and overnight messaging to both insurers and brokers advises them that this is happening. It provides references that link transactions connected with a single insurance contract to reconcile funds leaving one account and appearing in another.

In marine insurance contracts subject to English law, by virtue of the provisions of s.53 of the **Marine Insurance Act 1906**, the broker is in fact responsible directly to the insurers for payment of the premium. Clearly, this could put them in a difficult position should their client refuse to pay for any reason. In practice this section of the Act is not invoked and insurers can cancel contracts for non-payment of premium. Whilst the broker is usually the payment route, this particular legal situation does not arise in any other class of business.

In certain circumstances payment of premium to the broker is deemed to be payment to the insurer

Although the detail is outside the scope of this syllabus, it is important to understand the basic idea that in certain circumstances payment of premium to the broker is deemed to be payment to the insurer. One impact of this is that the insurer cannot complain that it has not received premium and try to cancel the contract. This topic is covered more fully in study text *LM2*.

D7 Provision of documentation to the client

Once the placing process is complete, the insured should receive a document evidencing their contract of insurance

Once the placing process is complete, the insured should receive a document evidencing their contract of insurance. This does not have to be a formal policy, although in some countries this is still a requirement. The insurers on the slip (MRC) can indicate whether the insured should receive a formal policy. If this is not required then the broker can issue either a copy of the MRC or another evidence of cover; for example, a **Broker Insurance Document** (**BID**).

The BID is the summary of the risk provided to the client by their broker, which sets out the key elements of the risk, rather than providing the client with either a copy of the full MRC or a formal policy.

Activity

If you work for a broker, find a copy of a BID and compare it to the MRC for the risk to see which information is transferred from the MRC to the BID.

The key point is that whatever the type of document ultimately issued, it must set out the details of the insurance obtained and be provided to the client no later than 30 days after inception. (Note that for some personal-type insurances, this period can be as short as five days, so it is important that the broker knows the requirements relevant to the particular class of insurance.)

Contract certainty is covered in chapter 5, section F

The requirement to provide documentation to the insured client is driven by a concept called contract certainty. This is discussed more in study text *LM2* but the core principle is making sure that **at the inception of the insurance contract** all parties are clear as to the exact details of the insurance agreement and that the client is provided with their paperwork promptly thereafter.

D8 Changes to the risk

If any changes are required during the life of the risk then the client should contact their broker who will then approach the insurers to advise them of the changes and to obtain their agreement. The agreement may be conditional on a requirement for more premium, or a change in the terms and conditions; however, it could be that premium will be returned – for example, if the change is that one of a fleet of ships has been sold and insurance for her is no longer required.

Once the change has been agreed with the insurers, the broker sends the information to XIS for recording, together with any necessary premium-related documentation. If a refund of premium is required then XIS facilitates the money moving from the insurers back to the broker.

E Broker's role in the claims process

In this final section we will review the broker's role in the claims process, again overlaying the theory from earlier in this chapter with the practical application.

E1 Claims notification

Should there be a situation which might give rise to a claim, the insured usually contacts their broker

Should there be a situation which might give rise to a claim, the insured usually contacts their broker. The broker plays a key role in assisting their client at this point – particularly in relation to maintaining evidence and any emergency practical actions to be taken. Different insureds have varying levels of knowledge and experience both of insurance and the claims process and the broker will therefore have to provide differing levels of assistance across their range of clients.

Consider this…

Personal lines customers (those purchasing household, motor and travel types insurances) are using brokers less and less as they are buying their insurances direct from insurers. Potentially, however, they would benefit the most from a broker's expert advice at the time of a claim.

At the first possible opportunity the broker advises the relevant insurers. The London Market has various claims-handling agreements which mean that it is not necessary for a broker to see all the individual insurers to obtain their decisions on claims matters. The broker contacts the necessary **Agreement Parties** to obtain their instructions which they then 'route back' to their client. Agreement Parties are discussed in more detail in study text *LM2*.

Agreement Parties are discussed in more detail in study text *LM2*

The broker can additionally advise their client as to the correct way to present their claim – for example, the documents that are required. Ultimately, this assists in streamlining the process for both parties.

E2 Appointment of experts

Insurers often appoint experts to assist the client and also to report back facts and information to insurers. These experts include surveyors, loss adjusters and lawyers, but the exact combination of experts is determined by the claim itself. The experts' reports are also usually routed back via the broker who:

Insurers often appoint experts to assist the client and also to report back facts and information to insurers

- provides a copy to their client; and
- presents them to the insurers for any further instructions.

Clearly, with the broker being the agent of the insured, should the insurers wish to appoint any experts to advise them concerning whether the claim is in fact covered under the policy, they should not do so via the broker.

E3 Negotiation

Just as the placing broker negotiates the placement of the risk, the claims broker has a negotiating role to play in those cases where the claim is not perhaps clear-cut. This does not mean that the broker has to negotiate each time but they add considerable value to their clients in negotiating points with insurers to assist with the resolution of the claim and to ensure that the claims process is as smooth as possible.

They also assist insurers, in that they can (where necessary) explain to their clients exactly why certain aspects or even the whole claim may not be covered.

Question 8.4

In which key way can brokers assist their clients in the claims process?

a. Paying the deductible for the client ☐
b. Negotiating with the insurers ☐
c. Collecting evidence from the loss location ☐
d. Filling in forms ☐

E4 Claims data

In the same way that risk data is centrally recorded by Xchanging from presentations made by brokers, claims data is also centrally recorded – but in this case solely for the Lloyd's Market. Another Xchanging company – in this case Xchanging Claims Services (XCS) – maintains the Lloyd's central claims database. The database is populated using presentations made by brokers, which can be in paper or electronic form, with the emphasis on using electronic presentations unless absolutely unavoidable.

Each night, data is sent out to each syndicate populating their internal systems with data on claims which have been updated during the day.

While there is no separate central database for company market, claims data is sent by the brokers to the individual company market underwriters electronically as well as via paper submissions. The difference with the Lloyd's Market is that the system into which brokers enter data is the **same system** that sends the overnight message data into the company insurers' systems and in which the individual insurers can view their own claims data, perhaps to compare with information in their own individual organisation's systems.

With Lloyd's, the brokers enter data into one system, XCS move it into another system, and this second system sends out the data to the insurers and triggers the movement of money for the syndicates. The syndicates cannot access this second system at all, and can only see the first system the brokers enter the data into at the front end of the process.

E5 Money movement

In the same way that premium funds are moved centrally by Xchanging, XCS move money centrally for Lloyd's insurers only. The system is exactly the same as for premiums, just with the direction reversed. They take the data from the broker, put it into their own system, send out messages and trigger money movement from that system.

For company market claims, once the correct combination of insurers agrees any particular settlement request from the broker, the claims system on which the data is held actually triggers money movement **automatically**.

Both claim payments and experts' fees can be paid out using these systems. Whilst payments are generally made to the broker who requested them, money can be paid to non-brokers as well – and often payments are made directly to lawyers and other experts. This is done by putting a different routing code into the systems – making sure that it is accurate first.

E6 Final stages of the claims process

The broker's responsibilities are complete when the client receives the claims funds 'in full and final settlement'

The broker's responsibilities are complete when the client receives the claims funds 'in full and final settlement' (and hopefully is happy, although this is not always guaranteed). Depending on the type of claim, the insurers may be considering some subrogation or recovery action and the brokers should remain in contact with them, as the insurers will often include the amount of any deductible or an uninsured loss within a combined action. Clearly, this will be of benefit to the insured as they might obtain refunds of these amounts if the claim against a third party is successful.

E7 Legal changes impacting the claims process

The **Enterprise Act 2016** which came into force on 4 May 2017 introduced a new remedy for insureds who believe that their claims have been paid late. They have up to one year after the claim was actually paid to file a legal action claiming damages for the late payment.

The Act introduces the concept of an implied term in every insurance contract that claims will be paid within a reasonable time, taking into account the circumstances which will include:

- the type of insurance;
- size and complexity of the claim; and
- any factors outside the insurers control.

A reasonable time also includes the time given to the insurers to review and assess the claim and the broker's role in trying to ensure that all the information required is available. In negotiating with insurers, the broker will assist both parties in relation to ensuring that the claims life cycle is no longer than it needs to be.

Key points

The main ideas covered by this chapter can be summarised as follows:

Legal basis of the broker's role

- Brokers are agents and are therefore subject to the general law of agency.
- Agency can be terminated by mutual consent, termination by one or other party, or by death, insanity or bankruptcy of either party.
- Brokers are generally agents of the insured, but in certain cases they can be agents of the insurers as well. For example, if they have a delegated authority of any kind.
- Agency can be created by consent, necessity or ratification.
- Brokers normally have Terms of Business Agreements (TOBAs) setting out the details of their relationships with their clients and also with insurers.
- Agents and principals have some key responsibilities towards each other.

Regulation

- Brokers operating in the London Market are regulated by the Financial Conduct Authority.
- Brokers do not need to be a Lloyd's broker to operate in the Lloyd's Market.

Services provided by intermediaries

- A broker is their client's professional adviser.
- A broker can in certain circumstances be working for insurers particularly in relation to delegated authorities.

Broker's role in the placing process

- In the placing process, the broker presents information to insurers and negotiates on behalf of their client.
- A broker's skill and knowledge will assist in the placing process.
- Premiums will generally flow through the broker in the London Market.

Broker's role in the claims process

- In the claims process, the broker presents information to insurers and negotiates on behalf of their client.
- A broker's skill and knowledge will assist in streamlining the claims process.
- Claims funds will generally flow through the broker in the London Market.

Question answers

8.1 The correct answer is c.

8.2 The correct answer is c.

8.3 The correct answer is d.

8.4 The correct answer is b.

Self-test questions

1.	Who are the two main parties in a simple insurance transaction?
2.	Who does the broker usually consider to be their client?
3.	If an agent acts outside their authority and their principal subsequently accepts their actions, what is this act by the principal known as?
4.	What is meant by the agent's duty of personal performance?
5.	What are the most common ways of terminating an agency agreement?
6.	Who regulates brokers in the London Market?
7.	What is the difference between a wholesale and a retail broker?
8.	What is the technical term for the payment that brokers receive from underwriters?
9.	If the broker has started placing the risk in the London Market, are there any insurers that they cannot approach?
10.	How are brokers involved in the payment part of the claims process?

You will find the answers at the back of the book

9

Underwriters

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Learning objectives

After studying this chapter, you should be able to:

- explain the role and responsibilities of underwriters; and
- explain the role and responsibilities of lead and following underwriters within the London Market.

Introduction

In this chapter we will be reviewing the role of the underwriter, the 'subscription' nature of the London Market and some of the issues that can arise if the risk is placed over a number of different contracts of insurance.

Key terms

This chapter features explanations of the following terms:

Competition law	Following market underwriters	Leader	Leading underwriter
Multiple placements	Subscription market	'Scratch'	Underwriter

A Role of an underwriter

In its most straightforward role, an underwriter is the person who makes the decision on behalf of an insurer whether to accept any risk presented. If the insurer accepts a risk, the underwriter determines the terms and conditions on which the acceptance is made.

The term 'underwriter' comes from the historic system whereby supporters would **write** their names under the details of any risk being presented (for example in the original London coffee houses such as Edward Lloyd's). By placing their name under the information on the paper presented to them, they were said to be **underwriting** the risk.

The term 'scratch' is often used for the combination of initials and a date that underwriters (and claims personnel) use to indicate that they have seen the presentation made. This term comes from the sound that was made – often with a quill pen – when they wrote their name as underwriters.

Insurance companies employ their own underwriters

In a modern insurance organisation, whether a company or a Lloyd's syndicate, there will be a number of underwriters – each with responsibility in their area of specialty, who are all employed by the investors in the business to accept risks (and hopefully make profits). In the case of a Lloyd's syndicate, they are employed by the managing agent which is the entity responsible for managing the syndicate on behalf of the Names (the investors). Insurance companies employ their own underwriters.

B Functions of an underwriter

When we looked at the nature of insurance in chapter 1, we talked about it as a 'common pool' where the contributions (premiums) of the many (people) pay for the losses of the few. In essence, the task of the underwriter is to manage this pool of premiums as effectively and profitably as possible. The main functions of the underwriter are therefore to:

- assess the risks being presented to the pool;
- decide whether or not to accept the risk and if so – how much of the risk to accept;
- determine the terms and conditions to be offered; and
- calculate an appropriate premium.

C Subscription market

In the London Market, risks can either be placed 100% with one insurer or on a 'subscription basis'

In the London Market, risks can either be placed 100% with one insurer (but this is rare) or on a 'subscription basis'. This means that more than one insurer participates in the same risk, each taking a fixed percentage of the risk.

Consider this…

Why might an insurer only want to take a small percentage of any risk?

An underwriter may only take a proportion of any risk offered for a number of reasons, as follows:

- **Size of risk and authority levels** – each underwriter has a level of personal authority granted to them by their employer, i.e. a maximum share in financial terms of any risk which they can accept.
- **Balancing the portfolio** – all underwriters constantly monitor their business to ensure balance across such areas as geographical exposures. It may be that the business already on the insurer's books almost fills the available capacity to insure a risk in a certain part of the world, so only a small amount of any later risk can be accepted.
- **Insurance broker input** – it might be that a risk is very good and the broker wishes to spread it amongst many insurers. The broker therefore tries to ensure that no insurer takes an overly large share for itself.
- **New class of business** – if an insurer is just starting out in a certain class of business then it is more prudent to take smaller shares in a number of risks in order to spread the exposure of its pool.

There are no rules as to the combination of insurers on any one risk and these combinations can include both London Market insurers as well as those from overseas markets. In cases where the insured is based overseas, it is quite common for the risk to be placed partially in their home market and then any balance remaining being presented to the London Market.

Mutual market

The notable exception to the concept of a subscription market is the Mutual Insurance sector, where the vast majority of the risks are accepted 100% by one insurer (e.g. the Protection & Indemnity Clubs).

In a subscription market, part of the broker's skill is to identify the best underwriter to approach first, to be the **leader** (or 'lead' or 'leading'). The leader's role is to:

Part of the broker's skill is to identify the best underwriter to approach first

- review the risk presentation being made by the broker;
- consider whether or not to accept it;
- decide the terms and conditions upon which to accept the proposal; and
- quote a premium.

The broker may approach a number of potential leaders to ascertain whether there is any significant difference in the terms and conditions that they are prepared to quote; they then present these to the client for their consideration.

Activity

Visit the website of an aggregator such as www.comparethemarket.com or www.gocompare.com and make a request for insurance. See how various options for possible insurance are presented to you. This is exactly the same concept as a broker presenting the quotes to their clients.

Question 9.1

Which of these tasks is not the responsibility of the leading underwriter?

a. Finding following markets ☐
b. Calculating the premium ☐
c. Deciding on the terms and conditions ☐
d. Considering the slip (MRC) ☐

C1 Characteristics of a good lead underwriter

The broker looks to the leader to put together an appealing quotation for the client, but if the leader does not accept 100% of the risk, the broker will then have to present it to other underwriters to see if they will support the quotation.

It is therefore essential that the leader is both able to provide a good quotation to the client and at the same time be credible and supportable by what is known as the **'following market'**. It is of no value to the broker to have a leader who has provided a quotation that no-one in the following market will support – meaning that the risk cannot be placed on those terms and conditions.

C2 Following market underwriters

A following market underwriter is one who is not deemed to be the leader

A following market underwriter is one who is not deemed to be the leader. However, it is important to appreciate that each underwriter who takes a share of the risk is creating a separate and distinct contract of insurance between their insurer and the insured – and they must consider the risk for themselves before they make that commitment.

Whilst the normal practice is that the following market underwriters agree with and support the leader's position, it is entirely possible that a following market underwriter might request more premium before agreeing to support the risk. If the risk is popular and the broker is not concerned about obtaining enough support from underwriters, the easy solution is not to use that underwriter. However, if the risk is proving more difficult to place, then the broker may need that underwriter to take a share of the risk.

Consider this…

What do you think happens next? Do you think that the leader and all the other followers should also get more premium? The answer to this conundrum is contained within principle 4 below.

The answer is not an automatic yes (unfortunately) as the leader and followers up to that point were fully prepared to write the risk on the lower premium terms and it would be prejudicial to the client suddenly to increase the whole premium on that basis.

The legal background for this principle is a concept called 'competition law'. Put more practically the law outlaws behaviour whereby the normal competitive nature of the insurance market is removed. It is also trying to prevent a situation where the market acts together to the detriment of the client.

The **European Federation of Insurance Intermediaries (BIPAR)** put together some high level principles concerning the placement of business with subscription markets and these are set out below:

1. The intermediary shall, based on information provided, specify the demands and needs of the client as well as the underlying reasons for any advice.
2. Before placing a risk, an intermediary will review and advise a client on market structures available to meet its needs and, in particular, the relative merits of a single insurer or a multiple insurer placement.
3. If the client, on advice of the intermediary, instructs the latter to place the risk with multiple insurers, the intermediary will review, explain the relative merits and advise the client on a range of options for multiple insurer placement.

   Intermediaries will expect insurers to give careful independent consideration to the option requested.
4. In the case of a placement of a risk with a lead insurer and following insurers on the same terms and conditions, the previously agreed premiums of the lead insurer and any following insurers will not be aligned upwards should an additional follower require a higher premium to complete the risk placement. Indeed, the intermediary should not accept any condition whereby an insurer seeks to reserve to itself the right to increase the premium charged in such circumstances.
5. During the placement of the risk, the intermediary will keep the client informed of progress.

As you can see from principle 4 the underwriters who previously agreed the lower premium cannot suddenly ask for more money just because someone else has successfully done so.

C3 Multiple placements

Even with the principles set out above, there will be situations where the insurers subscribing to the risk have agreed slightly different terms and conditions, whether that be the premium, the deductible or even the brokerage to be paid to the intermediary. If so, the practical result is that the broker must prepare and present multiple sets of information to Xchanging for the risk recording and premium transfer process.

C4 Handling changes to risks

In a traditional single placement the leader is easily identified and their role does not end with the placement of the original risk. It is important at this point to distinguish between the overall leader, the slip leader and the bureau leader:

In the London Market, the overall leader of a risk may in fact be overseas

- **Overall leader**. Earlier in this section we discussed the importance of the leader's credibility to other underwriters in addition to their ability to set terms and conditions acceptable to the clients. In the London Market, the overall leader of a risk may in fact be overseas and when the broker presents the risk to the London Market underwriters they will tell them the terms that the overall leader has set.
- **Slip leader**. The London Market underwriters are not obliged to follow the overall leader's terms – but for the moment we will assume that they do so. The broker may have gone to see a London Market leader in either the Lloyd's or the company market. If that underwriter is happy to lead the broker's London Market slip, they become the slip leader.
- **Bureau leader**. As we have already seen, there are no rules around combining Lloyd's and company underwriters on a slip with London Market security on it. If the slip leader is from a company then the first Lloyd's underwriter on the slip is called the bureau leader for Lloyd's and the slip leader is also the bureau leader for the company market (and vice versa for the company market if the slip leader is from Lloyd's).

This division of the London Market into Lloyd's and companies remains important insofar that the Market has a number of internal operational rules which seek to streamline the process for agreeing and advising changes to the risk, and the handling of claims. These will be discussed in more detail in study text *LM2*: *London Market insurance principles and practices*, but the key to all the rules operating smoothly is the easy identification of the key Agreement Parties for either changes to the risk, or to claims.

Within the structure of the slip/MRC there are sections for the parties to identify those who will be agreeing changes. An example of what this section would look like is set out in Figure 9.1:

Figure 9.1: Relevant section of the slip/MRC

Slip leader:	ABC insurer
(The heading name of Slip Leader, rather than Contract Leader, has been retained in order to maintain consistency with the GUA and other publications).	
Basis of agreement to contract changes:	GUA (February 2014) with Non-Marine Schedule (February 2014).
Other agreement parties for contract changes, for part 2 GUA changes only:	Slip leader only to agree part two changes.
Agreement parties for contract changes, for their proportion only:	DEF Company Ltd to agree to all contract changes.
Basis of Claims agreement:	Claims to be managed in accordance with: i) The Lloyd's Claims Scheme (Combined), or as amended or any successor thereto. *(N.B The applicable Scheme/part will be determined by the rules and scope of the Scheme(s)).* ii) IUA claims agreement practices. iii) The practices of any company(ies) electing to claims in respect of their own participation.
Claims agreement parties:	i) For Lloyd's syndicates The leading Lloyd's syndicate and, where required by the applicable Lloyd's Claims Scheme, the second Lloyd's syndicate and/or the Scheme Service Provider. The second Lloyd's Syndicate is JKL (1234). *(Where known by the broker, they may insert the second Lloyd's Syndicate name here – or may leave space for the relevant underwriter to apply their stamp below).* ii) Those companies acting in accordance with the IUA claims agreement practices, excepting those that may have opted out via (iii) below. *(The companies that apply the IUA claims agreement practices do not need to be individually identified here).* iii) Those companies that have specifically elected to agree claims in respect of their own participation. DEF Company *(Where known by the broker, the company(ies) electing to agree claims in respect of their own participation can be recorded here by the broker – otherwise this should be indicated by the relevant company(ies) placing their stamp(s) under this heading).* iv) All other subscribing insurers that are not party to the Lloyd's/IUA claims agreement practices, each in respect of their own participation. *(Companies that are not a party to the IUA Claims Agreement Practices will be handled under this category; they do not need to be individually identified).*

Post bind changes in particular are matters which brokers generally want to have managed as efficiently as possible, and one way to do that is to streamline the number of decision makers who have to be involved. The General Underwriters Agreement (GUA) referenced above is a default mechanism which divides changes into three categories being:

- Part 1 – non-material changes which will be agreed leader only.
- Part 2 – anything not in part 1 or part 3 generally which is leader and some agreement parties.
- Part 3 – material changes which should be agreed by all underwriters.

Any number of insurers can add themselves to the Part 2 agreement parties, but the broker would usually prefer a smaller number. There is no problem with the GUA not being used at all and another wording being used, perhaps allowing for any and all post-contract changes to be agreed slip leader only.

Consider this…

If you are a follower and all changes are slip leader only – how will you find out about them? Do you hope you will get a copy of the endorsement showing the change sent to you, might you see a premium payment coming through, or might you not know at all until a claim comes in?

If you work for an insurer speak to some colleagues to find out how you are advised of changes when you are not the leader.

If you work for a broker find out what is required to ensure all underwriters know about the changes, even if they are not agreeing to them personally

The leader is always involved in risk changes, but if you have a number of separate slips that have been created because of differences between the terms and conditions, then multiple leaders will have been created almost inadvertently. This causes difficulties – particularly with electronic trading – as far more parties have to be involved, which was never the intention.

Example 9.1

The broker starts the placing process by approaching insurer A with their slip. Insurer A agrees to take 25% of the risk but wants a deductible to be applied of £100. Broker then goes to insurer B, who is prepared to write another 25% of the risk but they want a deductible of £200. Insurers C and D agree with B about the level of deductible.

The broker has to be very careful as we saw earlier in section C2 not to breach EU rules. Therefore, they will treat the insurers separately and create two separate risk records with unique references.

In reality, insurer B never wanted to be a leader, but because they wanted different terms from Insurer A, they end up 'leader' of a contract with insurers C and D; insurer A is on its own on a separate contract.

Question 9.2

What is the name given to the leader of the London Market part of any insurance placement?

a. Overall leader ☐
b. Slip leader ☐
c. Market leader ☐
d. Main leader ☐

C5 Identifying the agreement parties for claims

As with risk changes, the London Market has in-built claims-handling agreements which seek to streamline the process. However, the market rules always apply and, unlike risk changes, insurers cannot add themselves to the decision-making group automatically.

The rules differ between the Lloyd's and company markets and will be discussed more in study text *LM2*; however, for each market the leaders are always involved as decision-makers. As with the risk changes, if the risk ends up being spread across a number of slips because of slight differences in the terms and conditions (which might have no impact on whether a claim is covered), multiple leaders will appear by default and the process has the potential to be slowed down rather than speeded up.

Particularly with the advent of electronic claims handling, the existence of more than one slip for any one risk creates 'ghost' leaders who suddenly have to become involved in claims-handling where they never intended to be when they originally wrote the risk. Whilst the various slips can indicate that one of them is deemed to be the leader and the others to be subordinate (i.e. not to be involved in any agreement) the systems cannot currently easily deal with that scenario.

Key points

The main ideas covered by this chapter can be summarised as follows:

Role of an underwriter

- Underwriters make the decision on behalf of the insurer as to whether to accept risks and on what terms and conditions.
- An insurer will employ a number of underwriters – each with an area of specialty.

Functions of an underwriter

- Main functions of the underwriter are to:
  - assess the risks being presented to the pool;
  - decide whether or not to accept the risk and if so – how much of the risk to accept;
  - determine the terms and conditions to be offered; and
  - calculate an appropriate premium.

Subscription market

- The underwriter who is approached by the broker to set the initial terms and conditions is called the leading underwriter or leader.
- There can be an overall leader outside the London Market, as well as a slip leader inside the market.
- The bureau leaders are the first Lloyd's and the first IUA company on the slip.
- Following market underwriters ('followers') are those who are not leaders.
- Followers are not obliged to accept the risk on the same terms as the leader and should always consider the risk independently.
- A follower can request more premium as a condition of their writing the risk, but the leader and previous followers cannot automatically receive more if this is the case.
- Market agreements exist to streamline the process for agreeing changes to the risk and for claims:
  - multiple leaders created by different terms and conditions being agreed by different insurers in the Market reduces the effectiveness of these agreements.

Question answers

9.1 The correct answer is a.

9.2 The correct answer is b.

Self-test questions

1.	What are the main functions of an underwriter?
2.	What does the term 'subscription market' mean?
3.	What is BIPAR?
4.	If the second underwriter that a broker approaches requests more premium than the first underwriter, should the broker return to the first underwriter to see if they also want more premium?
5.	Why would an insurer not take 100% of any one risk?
6.	Explain the difference between overall leader, slip leader and bureau leader.
7.	Which organisation is involved in recording risk data for insurers and transferring premium from the brokers to the insurers?
8.	If an insurer is not a leader, what is the term used for it?

You will find the answers at the back of the book

Chapter 1 self-test answers

1. Insurance does not prevent losses occurring but means that the financial impact of the loss has been transferred at least in part to insurers.
2. The main purposes of risk management are: identifying, analysing and controlling risk thus reducing the potential for loss, giving shareholders confidence that the business is being run properly and providing a disciplined approach to the quantification of risk.
3. An example of a high frequency/low severity loss would be minor car accidents. An example of a low frequency/high severity loss would be a refinery explosion.
4. An example of a non-financial risk would be the heirloom value of a piece of jewellery or a painting or the enjoyment value of a holiday. It is impossible to put a financial value on it over and above the market value of the object as enhanced value is very personal in nature.
5. Peril is the thing that will cause the loss, i.e. fire, whereas hazard is something to do with the risk that influences the operation or effect of a peril and has the potential to make the loss worse. Two types of hazard are physical (such as a thatched roof) and moral (such as a factory owner not bothering to train their staff to use machinery safely).
6. A speculative risk is one where there is a chance of making a gain as well as a loss which is why it cannot be insured. A pure risk is one where the best outcome is break even, e.g. getting to the destination on a train in one piece.
7. A fortuity is something that is unexpected or unintended.
8. By pooling together small premiums from many insureds, the insurer has the chance to build up an amount of money in order to compensate the few (i.e. pay claims). By pooling the risks, it is possible to charge a fair premium to each insured, representing the risk that they bring to the whole pool.
9. Primary reasons for insurance:
   - peace of mind/degree of certainty;
   - risk transfer; and
   - spreading the risk.
10. Motor third party liability insurance is the only compulsory insurance for individuals.

Chapter 2 self-test answers

1. The three most important essentials of a valid contract are offer, acceptance and consideration.
2. The consideration for an insurance contract is the premium being paid by the insured and the promise to pay claims by the insurers.
3. Insurable interest is a legal relationship between the insured and the subject-matter of insurance which could be a physical object or a liability that could be incurred.
4. Good faith is the duty on both sides to fully disclose material facts. An example of a material fact would be for a factory owner to disclose that the sprinkler system does not work or an insurer not disclosing amendments to terms and conditions of the policy.
5. Misrepresentation is telling the insurers something that is in fact incorrect, whereas non-disclosure is not telling them at all.
6. Proximate cause is the most dominant and operative cause of any loss and there is a direct link between it and the resulting loss. It may not be the last thing to happen from a time perspective.
7. Indemnity means putting the insured back in the financial position they were in before they suffered a loss.
8. The two methods – other than reinsurance – where an insurer can claim money back from other parties are subrogation and contribution.
9. The two main terms used for the first part of any claim payable by the insured are deductible or excess.
10. A reckless breach of the duty of fair presentation is where the insured knows they are breaching the duty but do not care that they are doing so.

Chapter 3 self-test answers

1. Builder's risk insurance covers the construction of ships.
2. You need fine art insurance.
3. Cash in transit insurers expect their insured to take various precautions such as:
   - varying routes;
   - different combinations of truck crews and making them armed;
   - using GPS and smart water technology; and
   - compliance with specific terms in the policy such as not leaving the vehicle unattended.
4. Political risk insurance will cover risks of assets being seized by authorities, companies prevented from working, personnel being evicted from countries as well as non-payment of debts by governments or other enterprises.
5. Fidelity guarantee insurance is suitable for a business wanting to insure against employees stealing money from it.
6. Business interruption (BI) covers the loss of income following some physical damage to a factory for example. It will pay out on the basis of a daily maximum indemnity figure that would be calculated based on historic business data for the company. The limits and excesses are expressed generally in days (the excess is known as a waiting period).
7. Examples of organisations that would be wise to purchase public liability insurance include shops, restaurants, local councils, nightclubs – anywhere where someone can be injured and might claim in court.
8. Personal accident is a benefits policy rather than a policy of indemnity.
9. The three groups of likely liabilities in aviation liability insurance are passengers, third parties other than passengers and products-related liability.
10. Any three of the four options:
    - for an individual risk;
    - for a certain class of business;
    - for a whole book of business; or
    - just for catastrophes.

Chapter 4 self-test answers

1. Supply is the provision of something and demand is the need for something but only at a certain price.
2. Tools that can be used to manage supply and demand include historic information, current information, competitive pricing and exclusiveness of the product.
3. Those insurances which are compulsory such as employers' liability, professional negligence and motor third party.
4. If the market is said to be in equilibrium, there is just enough supply to meet demand.
5. If there is more demand for insurance than insurers in the market, insurers will be able to charge more premium which will attract more insurers in as they think they will be able to make money.
6. After a major loss, supply may go down as insurers will leave the market as they have lost money.
7. A change in the law might make other insurances compulsory which will artificially create more demand for those insurances potentially attracting more players into the market who might be very aggressive on pricing to win market share.

Chapter 5 self-test answers

1. The investors in the Lloyd's Market are known as members or Names.
2. The syndicate is the grouping of Names taking on the risks. The managing agent is the organisation that runs the business and employs the staff; it is responsible to Lloyd's.
3. The Council of Lloyd's is responsible for the management and supervision of the Lloyd's Market.
4. A syndicate exists for one year to accept risks.
5. Lloyd's Names use members' agents as their professional advisers.
6. Premium income means the ability of an insurer to accept risks, often used as an indicator of the insurer's relative size.
7. Limited liability companies, mutual companies, mutual indemnity associations, captives and Lloyd's service companies can operate in the London Market.
8. The broker in the London Market acts as agent for the insured or reinsured.
9. The LMA represents both the managing and members' agents in the Lloyd's Market.
10. LIIBA and LMRC represent brokers operating in the London Market.

Chapter 6 self-test answers

1. The Financial Conduct Authority and Prudential Regulation Authority which obtain their authority from the Financial Services Act 2012.
2. The main objectives of the FCA are: consumer protection, integrity of the financial system and promoting effective competition.
3. Any three of:
   - A firm's head office, and in particular its mind and management, to be in the United Kingdom.
   - A firm's business to be conducted in a prudent manner — and that the firm maintains appropriate financial and non-financial resources. A firm's business to be conducted in a prudent manner — and that the firm maintains appropriate financial and non-financial resources.
   - The firm itself to be fit and proper and be appropriately staffed.
   - The firm and its group to be capable of being effectively supervised.
4. Fair treatment of customers is paying due regard to the interests of the customer and treating them fairly.
5. Whistle-blowing or making a qualifying disclosure is where an employee believes that one or more situations has arisen or is likely to arise, for example putting the health and safety of any individual in danger. An example would be advising the Health and Safety Executive of dangerous machinery and untrained staff in a factory.
6. If an insurer is regulated in its own state (its home state within the EU) then it can write risks in other EU states without requiring any additional regulatory approval from the other EU states as all the EU states respect each other's regulatory approvals.
7. Lloyd's obtains the permissions or licences centrally.
8. Three from:
   - the power to make rules such as byelaws;
   - management and superintendence of all affairs of Lloyd's;
   - right to exercise any of the powers of the Society of Lloyd's; and
   - power to direct the insurance business at Lloyd's.
9. The three categories of Members of Council are working members, external members and nominated members.
10. The Financial Services Compensation Scheme (FSCS) becomes involved if an insurance company is unable to pay its claims.

Chapter 7 self-test answers

1. Three from:
   - location of risk;
   - location of the broker;
   - premium tax or other tax payable; and
   - whether the business is direct or reinsurance.
2. Systems and controls include training and education, easy access to information, computer-based controls, peer review of work, system-based reporting and authority limits.
3. Sanctions are bans and the two main types are financial sanctions and trade sanctions.
4. OFAC is the Office of Foreign Asset Control, which is part of the US Government. It issues instructions which can impact on London Market insurers if they have US parents or links with US insurers.
5. London Market insurers with US parents must be mindful of US restrictions on trade including trade with Cuba.
6. Personal data is data that consists of information relating to a living individual who can be identified from that data, with or without other information that the data controller has in their possession.
7. Four from:
   - fair and lawful;
   - specified purposes;
   - not excessive;
   - accuracy;
   - processing and keeping;
   - data subject's rights;
   - protecting data, and;
   - data transfer.
8. The three stages in money laundering are placement, layering and integration.
9. You might suspect money laundering if the insured makes a request for you to pay the claim proceeds to someone who has previously had nothing to do with the policy.
10. The four offences under the Bribery Act 2010 are taking a bribe, bribing others, bribing a public official overseas and failing to prevent bribery.

Chapter 8 self-test answers

1. The two main parties in a simple insurance transaction are the insurer and insured.
2. The broker usually considers the insured to be their client.
3. If an agent acts outside their authority and their principal subsequently accepts their actions, the act by the principal is known as ratification.
4. The agent's duty of personal performance means not delegating authority given under an agency agreement to another without the permission of the principal.
5. The most common ways of terminating an agency agreement are mutual agreement, termination by one party or the other, death, bankruptcy or insanity.
6. The Financial Conduct Authority (FCA) regulates brokers in the London Market since April 2013.
7. Retail broker has the direct contact with the client, whilst wholesale broker has the contact with the insurers – they can be the same broker.
8. Brokerage is the technical term for the payment that brokers receive from underwriters.
9. No, the broker has the ability to approach any insurer in any market irrespective of whether any part of the placement is in the London Market.
10. Brokers play an important part in the claims process but are not liable to pay the actual claim, although they will usually receive the funds from the insurers to pass onto their clients.

Chapter 9 self-test answers

1. The main functions of an underwriter are to assess the risk being presented, decide whether to accept and if so how much of the risk, determine terms, conditions and calculate appropriate premium.
2. Subscription market means more than one insurer is participating in any risk.
3. BIPAR is the European Federation of Insurance Intermediaries.
4. No the broker should not return to the first underwriter to see if they also want more premium, because it is against the BIPAR principles for dealing with a subscription market.
5. The reasons why an insurer would not take 100% of any one risk are: size of the risk, authority levels, balancing against the insurer's pre-existing portfolio, broker input, or it might be a new class of business to the insurer.
6. The overall leader is the leader of the whole risk, irrespective of the market they are in; the slip leader is the leader in London and the bureau leader is the leader of either the Lloyd's or London insurance company placement.
7. Xchanging Ins-sure Services is the organisation involved in recording risk data for insurers and transferring premium from the brokers to the insurers.
8. If an insurer is not a leader it is a follower or following market underwriter.

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