

IAA Risk Book
Chapter 9—Distribution Risks
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1. Executive Summary

Each insurer uses one or more distribution channels to sell its products—insurance policies. These channels and their relationships with customers and potential customers represent a significant intangible asset of the insurer. Nevertheless, risks associated with the distribution process, including inappropriate marketing practices, create conduct of business risks. From a prudential perspective, these practices can pose a material risk to an insurer’s sustainability, brand value, and income-generating potential. The objective of this chapter is to describe and assess the major sources of these risks to which insurers may be exposed and the processes used to address them.

The key messages of this chapter include:

1. Although financial sustainability of an insurer is not often threatened by risks associated with its distribution system and marketing practices, these risks can lead to significant financial and reputational harm from lack of new business or poor quality of business, which can in turn adversely affect its income, brand value, and value as a going concern.
2. Distribution risks can result in risks to a distribution channel, to the insurer’s business, and ultimately to its financial sustainability.
3. Some types of distribution risks are similar to operational risks, which are unpredictable in nature, but can represent significant reputation and financial risks to the insurer.
4. Perceived concerns regarding sustainability or brand impairment of an insurer can result in a rapid deterioration of the size and effectiveness of the insurer’s distribution system.
5. Insurance market conduct supervisors are charged with ensuring that sales and service of insurance policies are made in a manner that delivers acceptable value to the consumer. Their policies and actions can include a range of consumer protection requirements such as suitability standards and disclosure requirements. In some countries, it is common for actuaries to sign off on the accuracy of illustrations of new sales/in-force insurance policies that clearly explain the mechanics of complex or long-term products and provide advice on the suitability of sales to customers.
6. Because of the importance of this risk, actuaries are involved in estimating the quality of sales, assessing policy performance in pricing insurance products, and helping to identify and measure distribution and conduct of business risks as part of the assessment of overall enterprise risk management (ERM) for the effective management of these risks.

This paper has been produced and approved by the Insurance Regulation Committee of the IAA on 8 March 2016

2. Introduction

Although sales are important in every industry, due to the complex nature of many insurance products and that in many cases they are sold rather than bought, they are especially full of opportunities and risks. Distribution risks are ultimately the responsibility of the insurer.

Effective new sales to and continuation of coverage of an insurer's customers are vital in enhancing the value of both insurers and their distribution channels, enabling them to operate soundly as effective and sustainable going concerns. Their customers may include individuals and commercial companies. Insurers conduct sales through one or more distribution channels (methods or processes of distributing an insurer's products), either (1) by agents¹ that represent a single or multiple insurers or (2) through other means, such as a website, mobile phone, or mail. Individuals involved in the selling process are often compensated through commissions and/or incentive rewards, often a percentage of the premiums paid or assets under management, or pre-set salary, possibly supplemented by bonuses or other incentives.

Agents that sell longer-duration insurance policies, some of which are complex and involve savings accumulation, are often paid more during the first policy year to reward successful new sales to customers or new policies to existing policyholders. There are also shorter-duration insurance policies, such as policies that provide group and short-term life insurance, motor, property, and other casualty insurance. Insurance can also be sold directly through partners (e.g., banks, micro-insurance institutions, and postal services) or other means (e.g., websites, phones, mail, or advertising).

There are many marketing methods used by insurers, nuances of which vary by market, coverage, country, technology available, and historical development of the insurer. In addition, an insurer can utilize multiple or hybrid forms of distribution methods. The appendix to this chapter provides a description of some of the most significant methods used in many countries.

¹ This chapter uses the term "agent" in a broad sense, including agents, brokers, and employees. In its Insurance Core Principle (ICP) 18, the International Association of Insurance Supervisors (IAIS) identifies this category as "intermediaries". They might also be distribution partners or sponsors that are responsible for or are involved in the distribution process, but whose primary business is not insurance and may not be licensed as an agent. They may be individuals or entities.

Differences between these types of agents can arise because an agent may be viewed legally as representing only one of the parties, typically the insurer, while a broker may be viewed legally as more independent, possibly having some level of fiduciary responsibility to the potential customer. ICP 18.0.9 indicates that (1) "where the intermediary acts primarily on behalf of the insurer, the intermediary sells products for and on behalf of one or more insurers, they are often referred to as 'agent' or 'producer'. Intermediaries may act for a single insurer (sometimes referred to as 'tied') or represent several. The products they can offer may be restricted by agency agreements with the insurer(s) concerned. (2) Where the intermediary acts primarily on behalf of the customer, the intermediary of the insurer(s) whose products he sells. Often referred to as a 'broker', or 'independent financial adviser', they are able to select products from those available across the market." As a result, many jurisdictions differentiate between the requirements of intermediaries defined in the supervisory framework as agents and those of brokers.

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There are three primary forms of “distribution risk”:

1. Risks to the distribution channel itself. The quality and sustainability of a distribution channel are subject to a range of risks, which in turn can affect the earnings and sustainability of relevant insurers.
2. Risks to the quality or volume of the insurer’s insurance policies caused by actions of the distribution channel.
3. Risks to the insurer as a company and to its future sales capacity caused by the actions of the distribution channel. These can include decreased volume and quality of business, misselling (i.e., selling an insurance policy inappropriate for the policyholder’s situation), and moving books of business in a way that may be inconsistent with the policyholders’ interests.

Insurance supervisors are also concerned with the effect an insurer and the distribution of its products has on the citizens of their jurisdiction. Distribution risks (such as inappropriate agent behaviour) and marketing risks (such as inaccurate marketing materials) are referred to together in this chapter as “distribution risks”. The distribution channel provides the connection between the insurer and its customers, with its attendant risks of unacceptable sales and marketing practice, especially with respect to those who are not financially or insurance savvy. Insurance supervisors are usually charged with oversight of appropriate product design and rates, including ensuring that insurance policies satisfy the needs intended and treat the insurers’ customers fairly. This is in addition to ensuring the sustainability of the insurance system and the insurers that make up that system. The complex nature and perceived lack of transparency of many insurance products, as well as the relative lack of knowledge regarding insurance risks and policy features, have resulted in the need for consumer protection, especially relating to sales of insurance to individuals. These consumer concerns have led, among other requirements, to the licensing of insurance agents, insurance rate regulation, and in some cases regulatory review of insurance products prior to their sale.

In some insurers, the marketing process is viewed as encompassing all elements of the development, maintenance, and management of new business and continuation of existing business of an insurer, from designing and rating its insurance products; growing, managing, and providing incentives for the insurer’s distribution channel(s); and communicating with and educating its agents and its customers, as applicable. In contrast, in other insurers the marketing function is distinct from the sales function, which has a separate organizational structure devoted to overseeing operations relating to the insurer’s distribution channels. In either case, marketing is involved with, if not responsible for, the development and management of its brand through such approaches as partnering, advertising, sales promotion, and sponsorships.

Some risks are joint risks between the insurer and its distribution channels, especially in the case of agents who are tied to a single insurer, whether as independents or as employees. For example, adverse events or publicity can affect both the insurer and the distribution channel, either directly as a result of data risks (such as cyber-risks or customer file hacking, or inadvertent incorrectly recorded transactions, not uncommon when the Internet or phone is

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involved) or in the extreme through criminal activity (such as fraud). If trust in the industry is adversely affected, both the insurer and the insurance distribution channel are negatively affected as well.

Although the emphasis of this chapter is focused on the risks associated with an insurer's distribution channel(s), it is important to note that the benefits of an effective distribution channel are quite significant to the success of the insurer. These risks can be assessed on a qualitative as well as a quantitative manner. Not only does the distribution channel(s) constitute the source of ongoing business and in some cases base from which policyholder services are provided, it can also serve as an effective mitigation tool against other business risks, including field underwriting, communicating the value of the insurer's brand, a positive relationship between the insurer and its customers, and positive influences with respect to market conduct.

3. Risks to the Distribution Channel

Given that effective and efficient distribution channels are of crucial importance to the generation of the future business of an insurer (including in some cases the continued profitability of existing business), risks to one of the insurer's distribution channels can in turn represent a substantial source of risk to the insurer.

Examples of such risks include a deterioration of agent continuity resulting from an aging sales force (for instance, in some developed countries a concentration of post-World War II baby boomers who are currently retiring); skilled salespeople who may not be skilled at being managers of field relationships and operations but have been placed or are chosen to serve as such managers; a poor reputation of its agents due to past inappropriate or fraudulent sales practices; new sources of competition to agents including mobile/Internet-based sales; more intense competition in the same type of distribution channel; poor sales management as evidenced by uncompetitive pricing, compensation, or support services; overconcentration of sales in a single agent or customer; managing general agents that are more focused on generating high sales volume than on generating quality or profitable (to the insurer) sales; and more modern technology that diminishes the relative effectiveness or efficiency of the current distribution channel.

Reputation risk to the insurer can, of course, arise from many sources in addition to the insurer's agents. For example, it can also arise from adverse publicity generated by agents of other insurers (the industry), bad claim practices, intense competition, government actions, or bad media relations.

Especially if the agent is tied to a single insurer, a negative reputation event will also likely lead to adverse publicity to the agent. A related example is that if an insurer's client data file is hacked, not only will there be a loss of customer privacy and possible adverse consequences to the policyholder, but the agent's relation with the policyholder may also be negatively affected.

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4. Risks to the Quality or Volume of the Insurer’s Policies Caused by the Distribution Channel

The distribution channel(s) and target market(s) of the insurer can significantly influence the type of insureds an insurer will provide insurance to, which consequentially results in different levels of expected insurance cost. Field underwriting² may influence the nature and type of exposures to risk that the insurer will be subject to. Examples of concerns include quality of insurance risks covered in relation to what is anticipated in the insurer’s pricing assumptions and policyholder behaviour (e.g., applications not placed, policyholder terminations prior to the policy’s expiry) and move business away from the insurer.

1. Risk selection. Often, but not always, agents directly or indirectly participate in the risk selection process through identification of customers and field underwriting, which may result in experience inconsistent with pricing assumptions due to potential anti-selection, policyholder moral hazard, or even fraud by applicants. Agents can be more focused on maximizing their personal revenue than maximizing profitable sales—particularly a concern with managing general agents who have been given significant autonomy with respect to the field underwriting and management of their individual agents. If an independent agent splits its business between more than one insurer, the business directed to a particular insurer might be of worse quality, representing adverse risk selection against that insurer. In addition, if an agent gathers incorrect or incomplete information regarding the quality of the risk, the insurer may as a result make incorrect underwriting decisions.
2. Policyholder behaviour. Although often thought of solely in relation to premature voluntary policy terminations and nonpayment of premiums relative to pricing expectations, policyholder behaviour also can result in moral hazard with respect to the expected amount of claims or in fraud. Agents can also influence inappropriate exercise of policy options—for instance, the exchange of one policy for another, especially one of another insurer, is often referred to as replacement. Such a replacement may not be in the best financial interest of the policyholder, as it might be the result of an agent more incented by large front-end commissions on long-term insurance policies or by a bonus for block-transfers of a book of short-duration insurance policies such as automobile or personal property insurance, than by the best interest of the policyholder. In fact, a replacement can indicate a situation in which a conflict of interest³ or misselling may be present. In some cases it may not be evident who “owns” the insurance policyholder relationship—

² Selection of potential insured risks by agents in the field, either judgmentally or in accordance with rules set by the insurer, often confirmed by an insurer’s underwriter.

³ A conflict of interest can arise where compensation is paid by the insurer for a sale of an insurance policy by an agent. Such compensation may incent an agent to steer a sale toward a product that provides a larger amount of compensation. It may especially arise where it is not clear whether the agent is working primarily on behalf of the insurer or the insured. This has led in some jurisdictions to a greater use of fees payable by the customer for the service of the agent or of required disclosures of the amount of compensation provided.

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this may result in alternative service responsibilities and movement of insureds between companies. In summary, agents can influence policy lapse or non-continuation behaviour counter to the best interest of the policyholders, which at the same time can impair the recovery of acquisition expenses or increase anti-selection against the insurer.

3. Policyholder interfaces. A lack of effective and convenient customer interface, whether via technology (website, mobile phone, or toll-free call-in number) can cause significant brand (and even industry) damage for an insurer and its distribution channels.

Actuaries regularly monitor policy experience and develop expectations regarding policy performance and policyholder behaviour, indicated by such experience as high policy lapse and low policy continuation; agent retention; and claim approval rates, changes in sales volume, and expense margins, which are incorporated in premium rates and valuation assumptions. Whether through internally tracked or external customer complaint sources (e.g., sponsored by regulators, independent firm or social network), complaint resolution metrics (by type, resolution percent, and timeliness) can provide useful feedback information to the insurer and supervisor. These are suggestive of distribution issues needing immediate insurer attention. As deviations from these expectations emerge, the insurer assesses whether its expectations need to be revised or corrective action is needed with respect to the insurer's distribution channel or underwriting.

5. Risks to the Insurer Caused by Distribution Channel Activities

The characteristics and quality of a distribution channel, or the effects of management decisions relating to a distribution channel, can also expose the insurer to direct damage in several ways.

Risks resulting from the operation of a distribution channel can include:

1. Concentration risk—that is, overreliance on a single distribution channel, a few agents, or a few insureds. In the extreme, this can be the result of over-dependence on the insurer on a single agent or relationship that could (1) adversely influence corporate policy, pricing levels or underwriting decisions; (2) adversely affect profitability; or (3) terminate a significant amount of business from the insurer if corporate decisions don't go its way. Alternatively, if, for example, a large portion of an insurer's sales are from agents located in a particular retail chain (such as a bank or department store), a decision by that retail chain to end the relationship may materially impact the insurer's financial position.
2. Outsourcing risk. If the management of a distribution channel has been outsourced to an intermediary (e.g., to a managing general agent) or to a partner (see partnering risk below), the insurer usually has less control of the channel and its business. Although this can result in high acquisition costs because of relatively high commissions/fees, this may be offset by the functions and services provided that the insurer no longer has to fund directly. The outsourced entity may be able to provide immediate scale or recruit more agents more quickly through which higher

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volume might be able to be achieved and access to new markets might be obtained, although the arrangement might at the same time contribute to increased concentration risk. Careful ongoing oversight may be required to overcome the direct loss of control.

3. Partnering risk. This can result from partnership with other firms, possibly with a bank (Bancassurance), a retail network, or micro-finance institution, with the responsibility for various functions, including distribution, split between the parties—the relationship involved is usually similar to the outsourcing situation. It should be noted that the more parties involved in the acquisition and servicing processes, the greater the likelihood of inadvertent or intended risks. In addition to the obvious risk of the partner becoming bankrupt, misaligned motivation and incentives, ineffective coordination, and a lack of an exit strategy may harm the insurer. In fact, the partner may be more involved with promoting itself than the success/profitability of the insurance co-venture; if, for example, a representative of the partner sits on the board of the insurer, that representative might influence the decisions of the insurer to favor the partner (as a result, many jurisdictions forbid agency firms to be on the insurer’s board). In the case of a bank partner that acted as a corporate agent, the partner could exert undue pressure and influence on the bank’s customers to purchase insurance policies passed off as investment products. If inadequately monitored and managed, a potential for misselling and fraud exists, which is bad for business both in the short and long term, representing brand and reputation risk for the insurer.

If the partner is responsible for collecting premiums, the insurer needs to monitor the delivery of premium payments directly to the agent or other intermediary, because they might never reach the insurer, resulting in loss of coverage by the policyholder and ultimately a loss of reputation by the insurer. This could also lead to significant increases in internal and external cost, including litigation costs. This type of risk, which may be widespread among insurers across a particular marketplace or isolated to a particular insurer, is similar to other types of operational risks, leading to loss of future new business. This risk can be exacerbated if the insurer delegates control and inadequately monitors the actions of the agents or managing general agent, as applicable. See Section 6 for further discussion of these risks and related issues of supervisory concern.

4. Cost versus control. The choice of a particular type of distribution channel requires an assessment of the risk of higher compensation, support cost, and effective oversight. Sudden changes in the cost, quality, or number of agents, especially involving a particular product or sector, have to be monitored on a regular basis. Indicators of such a change include unexpected changes in new business, not placement or lapse/continuation rates, outsourcer fees, or bankruptcy of outsourced agents. In any case, the actuary is sensitive to the level of expenses involved in the insurer’s operations, including the cost of acquisition—to assess relative competitiveness and the cost and success of agent recruitment—and care is needed to ensure that the agent does not benefit more than the policyholders.

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5. Up-front compensation. Insurers in many countries pay significantly greater compensation (to those generating the sales or those who are compensated by additional sales) at policy origination than at the time of renewal, e.g., long-duration life insurance sold to individuals. On the one hand this can align the interests of the agent and the insurer because in both cases a profitable product can create long-term capital/value for the insurer while providing capital to the agent to build and invest in the business of the agent. On the other hand, it can negatively affect the sustainability of agents as they can become dependent on new sales for cash flows and do not build up a continuing stream of income. In addition, it is important to recognize that this can create a conflict of interest as a result of an over-emphasis on placing new business by agents and on moving (replacing) blocks of business between insurers or between products of the same insurer, a reduced ability to recover acquisition expense, moral hazard, and, in the extreme cases, fraud. Whereas the insurer has an interest in retaining policies and policyholders to ensure recovery of its up-front costs, up-front compensation reduces the incentive for the agent to keep a policy in force, increasing the incentives for selling policies with higher compensation and for churning (replacing) the policy that may not be in the policyholder's best interest. Excessive compensation can prove to be a long-term detriment to consumers, especially for policies with a heavy investment component, e.g., privatized pension products previously sold in Latin America.
6. Expense recovery risks. Both greater expenses and inadequate new or total business volume relative to pricing assumptions can lead to a reduction in profitability. Although potentially caused by inaccurate actuarial estimates, this risk can also be caused by a sudden adverse change in distribution channel quality or effectiveness. This impaired expense recovery results from fixed or non-variable expenses or lack of new business or greater than expected policy lapse or non-renewal rates. Larger unit expenses are typically included as part of a stress test to assess the magnitude of its possible impact.
7. Rogue agents. In certain cases, an individual agent could act in a manner inconsistent with an insurer's policies and rules, or collude with a third party to take advantage of the insurer, another party, or society. The action might be illegal, such as modifying an insurance policy without the consent of the insurer, charging unauthorized fees, or acting in a fraudulent manner. Such action, once identified and reported to the supervisor or communicated to the public, can cause irreparable harm to the insurer's brand/reputation and cost the insurer a great amount of resources. This can be identified through monitoring of individual agents' business for early lapses, poor placement rates, or missold policies. An insurer can also inquire of peer companies or an applicable supervisor whether a prospective agent has been terminated with cause.
8. Tax payments. In some countries, the tax status of agents might change retroactively (e.g., from being an independent contractor to an employee), possibly resulting in considerable tax payments or penalties for the insurer and restructuring of its distribution strategy.

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9. Technology/regulations. New technology or new regulations can make the current distribution process irrelevant or overly expensive. An example of the use of new technology includes mobile phone apps used to purchase or pay premiums for insurance. For instance, new regulations may require additional continuing education requirements or fiduciary responsibilities, which may result in increased cost or inability to recover previous sunk cost.
10. Uncollected chargebacks. In some cases, commission will be charged back to an agent out of future commissions if long-duration policies lapse in their first policy year. However, if an agent severs its relationship with the insurer, the chargeback may become uncollectable.
11. Multi-level marketing. Ponzi, or pyramid schemes, where agents are compensated upon recruitment of additional agents, might arise, although rare in insurance. These situations, banned in several jurisdictions, can benefit agents, but eventually run their course to the benefit of no one, other than the first few participants in the scheme.
12. Political risk. If the agent or sponsorship is provided by a government or governmental agency, if the head of that government or governmental agency changes or changes policy, or if fraud or kick-backs are proven, the relationship and business can be adversely affected, especially if a large part of the business of the insurer.

Poor management governance practices related to its distribution can also weaken insurer performance. These can include:

1. Ineffective or unsuitable distribution channel. A poorly designed or managed distribution channel can develop a low quantity or quality of insurance sales and create a poor public image for the insurer. It can be unsuitable if it is not appropriate for the needs, knowledge, or culture of the target market. This may be as or more important than unsuitable products in providing quality products.
2. Management resource risk. It is often a priority to maintain the loyalty of top agents. This may require considerable time by top management and its employees in agent relationships to maintain their loyalty. Although this may be a consciously chosen business priority, it also might divert an inordinate amount of top management time from important strategic issues and toward quantity rather than quality of business.
 - a. Over-emphasis on gaining market share. In some cases, the emphasis of management can be so focused on gaining or defending market share that the quality of its distribution channel, agents, and insurance risks suffers. This can arise when staff in charge of sales or marketing emphasizes increases in sales at the expense of quality of agents, sound underwriting practices, or premium adequacy. An early warning signal of this happening might be a surge in market share that cannot be explained by another factor. Regular discussions with agents can provide insight into the underlying reasons for such a change, which can then lead to appropriate corrective actions.

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3. Inappropriate product and pricing governance. Mitigation efforts include the design of products suitable to the distribution channels used and target markets, and costs consistent with desired level of competition and risk tolerance.
4. Sponsorship risks. Advertisements and sales can be augmented through the endorsement or other use of sponsors and brand salespeople, such as a celebrity. As with any marketing effort, a deterioration in the reputation of the sponsor, celebrity, or agent can result in a significant reduction in the marketing potential of the insurer, although that might prove temporary with timely action by the insurer.

Because of the importance of these risks to the insurer, actuaries are involved in estimating the quality of sales and policy performance in the pricing and valuation of insurance products, as well as in the ERM assessment of the effective management of these risks and distribution performance. Effectiveness and accuracy of sales material, whether in sales brochures, presentations, policy illustrations, website, or mobile phone apps, can be pre-screened or audited, as applicable and needed. Although not normally involved in agent training, actuaries can be involved in the development of educational material regarding the products and needs addressed by the products. This involvement not only enables insurers to better identify these risks, but to also develop or enhance the mitigation tools that can reduce the incidence and management of the severity of these risks.

6. Consumer Protection/Selling Risks

Insurers owe their customers a duty of care, which goes beyond simple compliance with laws and regulations. Since either their agents or other contacts with customers are usually provided indirectly through others or by means of technology, distribution and sales risks need to be soundly managed. As a result, the protection of consumers against inappropriate market conduct risks is quite important and should be within the scope of an insurer's ERM. A culture of fair business conduct, responsible pricing, and claims management is a key element of this area of risk management—both top-down and bottom-up methods and emphasis are needed to properly fulfil this important function.

In addition to assuring that contractual promises made by an insurer are kept by means of regulatory standards and supervision of those insurers, insurance supervisors are also often charged with ensuring that the customers of an insurer are treated fairly and are sold policies that meet their insurance needs. In some jurisdictions this supervision is conducted by the same supervisory authority as the supervisor charged with ensuring the solvency of insurers, while in others they are separate.

As a result, supervisors may regulate and monitor certain aspects of rates, products, and agents. This can be done, for instance, in areas such as rate and policy form approvals, minimum standards for policy illustrations and disclosure, remuneration limitations, and agent licensing.

It should be noted that certain regulatory rules designed for agent-based distribution may not be suitable for situations in which an agent is not involved. Supervisors in some less developed jurisdictions may not have adequate resources, rules, or ability to assess penalties for noncompliance. In addition, the regulation of distribution of insurance sales or products

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may fall in the cracks between supervisors with specified responsibilities—for example, between different industries/products or solvency/distribution. In some cases, not all those involved in the selling process may be required to satisfy minimum knowledge and experience in the insurance area.

Insurers are subject to conduct of business risk.⁴ Effective management of this risk consists of both operational (process) and strategic (determining the business model followed, including distribution and marketing objectives) elements. A key component of this management is early identification and avoidance of inappropriate market conduct, which can ultimately lead to or be suggestive of future lack of sustainability and sound financial condition, which in turn represents a prudential solvency risk. In addition, they may be a symptom of ineffective governance and lack of internal controls over an insurer's distribution process.

Inappropriate market conduct and lack of consumer protection can result partly from an asymmetry of knowledge regarding insurance and insurance policy features and practice that may be complex and include many technical aspects. This asymmetry is presumed to be more pronounced where the buyer is an individual (such as in the purchase of individual life insurance, micro-insurance, and personal automobile insurance) rather than where the buyer/sponsor is a commercial enterprise (such as is the case for group insurance, commercial liability, or reinsurance). This concern may also arise in less developed markets and jurisdictions. More consumer protection is needed where greater asymmetry exists.

Risks relating to a failure to adhere to regulatory-mandated or generally accepted behaviours, particularly if an insurer or its distribution channels take advantage of this asymmetry to the detriment of customers, are referred to as conduct risks in many jurisdictions. In this century some financial services companies, especially but not exclusively banks, have incurred large fines due to inadequate management of conduct risks. In some cases, conduct risks have been a significant driver of operational risk losses.

Insurance market conduct supervisors are charged with ensuring that sales of insurance policies are conducted in a manner that delivers acceptable value to the consumer, often resulting in consumer protection requirements, including relating to policy features and illustrations of new sales and in-force policies. In some jurisdictions the content of policy illustrations is highly regulated, while in others it is primarily self-policed.

In highly regulated jurisdictions, actuaries are often involved in preparing the values and descriptions of the content of policy illustrations and may be subject to actuarial standards. In self-policed jurisdictions it is especially important that objective advice be provided to those preparing the illustrations, particularly in jurisdictions with less developed insurance markets, where actuarial involvement can be beneficial to help ensure that they are objectively and accurately prepared and are accompanied by understandable information and education, which should be conveniently accessible.

⁴ Risks to customers, insurers, the insurance industry, or the insurance market that arise from the conduct of insurers and/or their distribution channels in developing and managing their business in a manner that may not fairly treat their customers. For further discussion, see the IAIS Issues Paper on “Conduct of Business Risk and its Management”: <http://iaisweb.org/index.cfm?event=getPage&nodeId=25244>.

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User-friendly educational information and clear and concise disclosure suitable to the market concerning the workings of insurance (not excessive, as that will likely be ignored by most consumers), provided by insurers, agents, supervisors, schools, or the media can help mitigate any asymmetry and enable consumers to make more well-informed insurance decisions. The sophistication of disclosures should be tailored, where possible, to the knowledge of the users—this is valuable even when middle- and upper-income individuals have enhanced their knowledge through readings about insurance from the Internet or from price comparison websites. Less complex and clearly written policies and policy features can help, especially in less developed markets and jurisdictions. This is particularly important where investment risk is not transferred to the insurer, where there are benefit deductibles and exclusions and possible rate increases, or where the policyholder may not understand all available benefits.

Fairness in treatment may include ensuring that rates charged are not unfairly discriminatory among classes of consumers and that the insurance policies offered adequately meet the needs of the consumers and that they are not overcharged. Concerns over excessive premium rates have arisen for products such as credit life/health insurance (where the consumer is more interested in the loan than in the insurance, so may be subject to excessive premiums in relation to the cost of insurance) and extended warranty coverage, while also for policy fine print, which are inconsistent with policyholder expectations and may affect benefits and claims. Such situations may result from ineffective competition at the consumer level and a lack of informed choice.

Since the distribution system plays an important role in the effective delivery of insurance policies, insurance supervisors are concerned with the effectiveness of the distribution system in soliciting new customers and servicing existing customers. This has led to the licensing of insurance agents to help ensure that these agents have achieved and maintain an acceptable level of knowledge of insurance policies and insurance and financial needs—put in place to provide a framework for regulatory compliance and supervisory oversight.

In response to situations where insurance policies have been missold to consumers (that is, they are not suitable to satisfy the specific consumer needs for which the product was designed), possibly due to the incentives that led to up-front compensation to agents, supervisors have enforced certain consumer protection rules and, in extreme cases, redress. Depending on the market, type of insurance purchased, and individual involved, an insurance consumer may not have sufficient knowledge to completely understand the insurance policy, including its benefits and obligations. In certain cases, an agent or sales information might suggest, through explicit or implicit means, an insurance policy or amount of insurance that is inappropriate for a particular consumer. In others, benefit/claim limitations or exclusions are not clear. In some cases, a pattern of misselling has resulted in substantial fines of insurers or compensation to consumers, which can also result in a significant reduction in the insurer's brand value.

Examples of misselling include: pension misselling in the United Kingdom, credit and payment protection insurance, selling a payout annuity to someone who is seriously ill, inappropriate tax advice or use of a policy designed to dodge a tax rule, the sale of a product designed to help customers in a different income tax category, and inadequate disclosure of

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the need for a separate flood or earthquake policy to a customer with material exposure to such a hazard.

As mentioned above, historically, compensation provided by the insurer to agents who sell long-duration insurance policies, especially permanent life insurance, has been front-ended—that is, agent compensation in the first year of the insurance policy is much larger than in subsequent years. This has generally reflected the significantly larger investment of time needed to sell these policies than needed to service them. This can create a conflict of interest that can incent the agent to churn the business and has led to cases of misselling, or even fraud.

In some jurisdictions there has been a recent move toward increased disclosure of agent compensation and in some cases has led to the use of fees charged to the insurer's customer instead of compensation provided by the insurer. Advocates of this change have claimed that this will contribute to more objective advice. In several areas, some supervisors have limited insurer expenses—for example, the state of New York in the United States has limited the expenses of insurers in an attempt to provide more value to consumers, while in the United Kingdom the insurance supervisor has conducted a review of "value for money" across numerous life and pension products. Due in part to concern with potential conflicts of interest, other supervisors have capped agent commissions at a certain maximum percentage, possibly a function of services provided, have banned or restricted certain commissions or other incentives, or required disclosure of commissions received.

Insurers, through a range of techniques, provide consumer protection that at the same time manages sales risks. For instance, these controls can include initial agent screening, training and continuing education programs regarding product features and proper sales techniques and sales process rules and requirements, agent compensation and sales targets that consider the implied incentives, agent discipline, periodic audit of sales processes, legal review of all advertising and sales promotional material, and consumer education programs. For distribution channels that do not involve agents, these include technology-efficient and consumer-sensitive information. Various techniques are available to ensure high quality distribution process, including the use of sales audits, customer satisfaction surveys, and a responsive independent sales ombudsmen function.

These techniques not only provide consumer protection, but also protect the insurer from harm from distribution risks. In particular, they are managed and monitored by the insurer's sales management and on the whole as part of insurers' internal audit and ERM processes. Consumer recourse, redress, or consequential adverse publicity, a full discussion of which is outside the scope of this chapter, can be provided by many means, including through consumer complaint services such as a supervisory or other consumer entity or reported on an Internet website set up for this purpose.

Actuaries have also been involved in helping to control these risks. In some jurisdictions these activities have included signing off on the accuracy of illustrations of new sales/in-force policies that clearly explain the mechanics of long-term products and provide advice on the suitability of sales to customers.

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7. Conclusion

Distribution- and marketing-related activities, although not often thought of as serious solvency risks, can represent significant financial risks to an insurer, as well as to its customers. In particular, inadequate management of an insurer's distribution channel and agents can lead to situations with adverse consequences to an insurer's sustainability, brand value, and income-generating potential. In addition, supervisors are concerned with inappropriate sales and service, which require consumer protection and consequential action against sales practices and ultimately affect the advisability of allowing the insurer to operate as a going concern.

Sound management of distribution risks will enhance and maintain the value of and trust in the insurer as an ongoing concern. These risks have to be protected against, using such elements as:

1. Key performance indicators of the performance of individual agents, intermediaries, and distribution channels addressing the number of customer complaints by type, retention rates of written business, surges in sales not seen company-wide, and possible fraudulent red and yellow flags seen in new business;
2. Use of actuarial standards for suitable policy illustrations of long-term products, where applicable;
3. Agent and consumer education as to suitable consumer needs for the offered products;
4. A possible independent, accountable function (such as ERM) including the monitoring of sales practices and suitability processes and their risks; and
5. Regulatory requirements that govern market conduct and sales practices, as well as reviews that can assess the effectiveness of the insurer with respect to disciplining/educating/managing its distribution systems.

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Appendix—Types of Distribution Methods

There is a wide range of distribution methods in use by insurers, the relative importance of which depends upon the market, the coverage, available resources, technology, and historical development. An insurer can utilize multiple channels, often one for each business unit, although some business units also utilize multiple distribution channels. Agents (see footnote 1) serve as intermediaries between the insurer and the ultimate insurance consumer, and can be an individual or take the form of an agency, a group of individuals. An agent can specialize in a particular type of insurance product or sell many types. In addition, an insurer may use a combination of these methods in a particular market, e.g., through leads generated by direct or website contacts, followed up by contact from independent agents or insurer employees.

A distribution channel may involve more than one distribution approach or a hybrid method, and that any categorization represents an overlap of approaches, e.g., a full-time career agent may be an employee of an insurer or independent, and a sale may involve both website and agent. The following is one categorization of distribution channels:

1. Full-time (tied or captive) career agents. They can be employees or independent contractors who represent a single insurer, primarily involved in selling that insurer's products. The classification as an employee or independent contractor can result from tradition or tax laws. A new agent can be subsidized for a period to allow for training and development of customer relations.
2. Salaried employees. They sell products directly to the customers of the insurer. This approach is often used in sales to large accounts—for instance, selling group life/health or commercial property/casualty insurance to large corporations, or direct insurers in the case of reinsurers. Salaries can be fixed or can include incentives /bonuses as a reward for successful sales.
3. Independent agents. These are not employees of the insurer. They can be brokers, who can represent multiple numbers of insurers, or those who only sell insurance provided by a single insurer. Their primary business may or may not be to sell insurance products.
4. Consultant-led agents. In some market segments, particularly institutional ones, clients employ specialist consultants or advisers to help consumers select between competing providers. Regulatory trends tend to differentiate between agents remunerated solely by the client and the sorts of independent agents referred to above who may traditionally have been remunerated primarily by the insurer. Some insurers' distribution risks diminish if the gatekeeper to the client is remunerated by the client rather than the insurer, but other risks increase, such as the risk of falling out of favor with leading consultants for that market segment.
5. Partners. Sales can be generated by or as a result of a partnership with a wide variety of industries that would not otherwise specialize in selling any insurance or the insurance of the type sold. This can involve working with partners or sponsors, sometimes with their own existing networks, whose primary business is not insurance. In some cases, they may not be licensed as an agent. This may provide

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an entrée, possibly in the form of bundled products, to potential customers that they would not otherwise be able to access. In some jurisdictions, this includes Bancassurance, in which banks participate, either as an affiliate, partner, or distributor of an insurer's products. Other examples include retail chains, telecommunications entities, micro-finance institutions, trade unions, and post office outlets. Others can sell insurance:

- a. As a consequence or coordinated with the sale of related products, e.g., financial institutions at the time loans are provided and mortuaries (e.g., pre-need insurance) in anticipation of a future burial.
 - b. That specialize in other types of insurance. For example, sales of life insurance by those who primarily sell property and casualty insurance.
 - c. As part of a broader portfolio of products, e.g., other financial institutions and asset managers, especially for wealth products such as annuity, pension, life insurance, and savings products, by employees of the financial institution or the insurer embedded in that related or unrelated companies' operations.
6. No agent involvement. Many variations of distribution channels that do not involve or require sales representatives of an insurer exist. In some cases, particularly where a method does not involve an agent to attract a potential customer, an agent who may specialize in insurance will become involved to provide advice or close the sale. They include:
- a. Website. Sales are obtained through use of a website, often from customers searching for a suitable insurer or insurance policy. In some jurisdictions, an increasing percentage of sales are conducted through the Internet (for example, based on price comparison websites⁵ (PCWs), which may not be able to match needs with product, and may increase the risk that a policyholder decides on a policy solely on price rather than quality or consistency with the individual's needs). Needs for insurance may be established through information obtained on the website or exchanged through social media.
 - b. Mobile phone. Insurance is sold through or with some assistance provided by a mobile network operator, which may pay premiums on behalf of its customer as long as there is a minimum amount of phone usage in the period.
 - c. Advertisements. This method can either be aimed at enhancing an insurer's brand or enticing potential customers to inquire about the insurer's specific products.
 - d. Direct. Sales through this approach can be made through the mail (post), phone solicitation, or through various technologies.

⁵ In the European Union, the Insurance Distribution directive considers PCWs to be an insurance intermediary.

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- e. Affinity/loyalty. Sales are made through an affiliation of the customer, for example, through an association, labour union or cooperative where the customer is a member or through workplace schemes.

Some insurers have bought blocks of business from other insurers, if not through acquisition of an entire insurer, sometimes obtained through the use of an investment banker. In some cases this block of business or insurer is put into run-off mode—that is, the distribution system used to produce the business does not actively pursue new business for the insurer. Not only are the normal risks associated with deviations from expected experience (e.g., policyholder behaviour, mortality, or claims), but if inadequate due diligence was performed, they might include the cost associated with selling risks including misselling practices generated under prior management.

A managing general agent is a company or agency that controls the means of distribution, usually by means of multiple sub-agents. In some cases, in return for additional compensation it is responsible for specified marketing or other servicing functions.

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