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The art of delegation: delegated authorities in the insurance sector

In this article, we look at the part that delegated authorities play in general insurance, and some of the issues surrounding this form of outsourcing. We also consider industry best practice.

Background

The rationale for delegating underwriting or claims handling authority is basically the same as for any other form of outsourcing. Insurers choose to delegate when they believe it to be more cost effective and practical to hand over their underwriting pen to a third party who can accept business (or process claims) on the insurer's behalf.

The extent of delegation can range from the intermediary (referred to as a coverholder) simply having the authority to issue documents on the insurer's behalf, through to a full 'binding authority' agreement where the coverholder can set the policy terms of cover and premium rates without having to obtain the insurer's prior agreement for each individual policy.

Similarly, an insurer may choose to outsource some, or all, of its claims handling to the coverholder that holds the delegated underwriting authority. Insurers can also outsource claims to a third party administrator (TPA). The TPA is generally a stand-alone firm that specialises in claims handling.

Growth of delegated authorities

Delegation of underwriting and claims handling by insurers to managing agents (MGAs) and other insurance brokers is a significant part of the way forward for the growth of general insurance. This applies especially to products that can be commoditised, and which are targeted at the consumer and small-medium enterprise (SME) market.

> "Coverholders are key to the growth of the London insurance market."

InsurTech is a highly innovative area for exciting new products being launched by entrepreneurs who generally operate as MGAs/intermediaries. These products are often low cost with high sales volumes. Without the backing of an insurer who is prepared to grant them delegated authority to write the business in a streamlined cost efficient way, many of these entrepreneurial start-ups would struggle to get off the ground.

Coverholders are key to the growth of the London insurance market. Many of the large composite insurers and other carriers also rely on delegated authority arrangements to bring in a significant proportion of their premium income. While there is always a place for retail insurers who deal direct with their policyholders, many carriers do not have the infrastructure or desire to deal direct. Such wholesalers actively look to grow strategic business partnerships with brokers, as part of their business models. In many cases, the carrier's business model and strategy includes delegation of authority to selected brokers.

Conversely, there will be some insurers wishing to reduce the number of their coverholder relationships. This can be down to commercial reasons where the contracts are not profitable, or following a change of business strategy. It may also be due to the increased operational and regulatory risk that comes with delegation and outsourcing.

What the regulators expect

Regulators tend to look at insurers and brokers who outsource via delegated authority with greater scrutiny. Longer chains of distribution can result in increased complexity, as well as weaker oversight and control by the principal over the performance of products and delivery of services. Insurers (and other parties in the distribution chain) who do not have robust governance and oversight over their outsourcing arrangements may not be aware of how their end-customers are being treated. They may also be unaware of the impact on their bottom line and threshold conditions. The FCA's 2015 Thematic Review TR15/7 sets out key conduct issues affecting insurers and brokers that delegate authority in the general insurance market. These issues remain relevant today. Later in this article, we go on to describe what good delegation entails, taking account of the FCA's findings from their review.

It is crucial for firms to have the right systems and controls in place, together with clear allocation of responsibilities to ensure good oversight of delegated activities, both from a regulatory and commercial perspective.

Why delegation is a key part of the market

Delegation means that insurers can use niche product providers/distributors who have expertise in a particular class of business (such as, pet or health insurance), rather than having to develop and maintain a specialist in-house team. Insurers can write business in certain overseas territories via coverholders without the expense of setting up their own local infrastructure. The coverholders usually have the requisite knowledge of the region and established local relationships.

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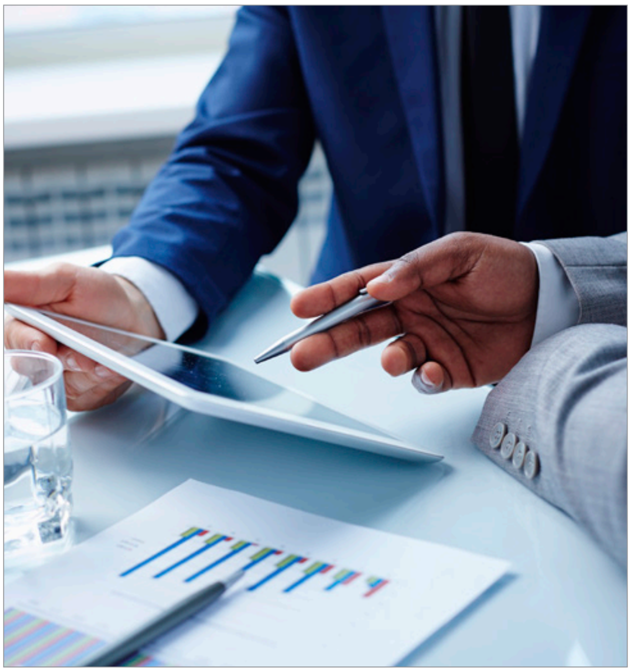
Another benefit is that insurers can test the waters in new areas by using specialist coverholders before investing and committing themselves long term to a new line of business. Product innovation often happens through the use of delegated authorities.

The coverholder can benefit from partnership with the insurer by gaining access to the insurer's brand, security and ratings. Policyholders gain from wider competition and access to local and/or niche distributors and product providers.



Potential disadvantages

Outsourcing and longer chains of distribution can result in weaker oversight and control by the principal, as noted above. This can become more of a problem when sub-delegation is involved, with a number of intermediaries in the value chain between the insurer and the end-customer.

Delegated authority does not work well if the coverholder is poor at managing its business, does not comply with contractual or regulatory requirements, produces poor underwriting results or treats its customers unfairly. An insurer runs the risk of taking on more than it intended if the coverholder acts outside its authority, even if there is a right of recovery against the coverholder.

Where activities are not properly segregated, there may be a conflict of interests when a coverholder is acting as agent of both the insurer and of the policyholder.

What good delegation looks like

The key to good delegation is setting up a robust framework for the governance and oversight of delegated authorities. Some of the key elements of such a framework include:

1. Strategy and risk appetite

- A delegated authorities strategy and risk appetite that is aligned with the principal's wider business model and strategy.

2. On-boarding and regular review of coverholders

- Selective appointment of coverholders with the right qualities and experience, using comprehensive on-boarding and due diligence processes and procedures.
- Clarity over potential conflicts of interest.
- Maintaining a holistic view of each coverholder through ongoing risk based monitoring, regular reviews of contracts, relationship management regular management information and coverholder audits.
- Good quality, up to date management information that is regularly reviewed and acted upon.

3. Roles and responsibilities

- Clear documented allocation of responsibilities including:
  - who is acting as product provider;
  - product design and marketing;
  - extent of 'know your client' and sanctions screening by coverholders;
  - ongoing monitoring of product performance in terms of value for money, customer outcomes and underwriting risk.
- Clear contracts with coverholders covering, amongst other things, principal's rights to audit, access to data, management information requirements, service level agreements, and conduct standards and expectations.
- Clarity over sub-delegation arrangements including appointed representatives of coverholders.

4. Coverholder audits

- A structured coverholder audit framework and plan, in line with typical audit standards and which provides objectivity/ independence.
- Quality and consistency of coverholder auditors with effective audit action tracking and follow up procedures.

5. Internal escalation procedures

- Clear internal escalation procedures, e.g., for dealing with coverholders that fail to perform or comply.

To summarise, robust systems and controls to mitigate conduct and prudential risks together with clear allocation of responsibilities are essential to the art of good delegation.

Teresa Mazur – Associate Director
teresa.mazur@moorestephens.com

Ian Gardner – Partner
ian.gardner@moorestephens.com

Moore Stephens LLP
150 Aldersgate Street, London EC1A 4AB
T +44 (0)20 7334 9191
www.moorestephens.co.uk