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OFFSHORE LIFE INSURERS FACE NEW CONDUCT OF BUSINESS RULES

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In the race towards greater regulation and the codification of requirements to treat customers fairly, the general perception is that the Isle of Man life sector was lapped some time ago. Now, however, the imminent introduction of the Insurance (Conduct of Business) (Long Term Business) Code 2017 means that - by the end of the year - the sector will have re-joined the main bunch; soon it may even be nudging ahead. Unfortunately, this is a race with no finishing line and probably no winners.

The draft Code published by the Isle of Man Financial Services Authority (**IOMFSA**) in May is expressed to constitute a "final consultation". In reality, we can expect the Code to be enacted in materially identical terms. Therefore many offshore life companies face a tough timetable to introduce significant changes in their internal governance and customer processes. Those businesses that are not already well advanced in implementing the associated culture change will find that this compounds the challenge.

The Code enshrines a "treating customers fairly" requirement, as well as more specific and prescriptive conduct of business obligations. The key areas when the Code bites are as follows:

- **Policyholder onboarding:** pre-contract disclosure, cancellation rights and ongoing disclosure
- **Broker relationships:** prescriptive terms of business requirements and ongoing monitoring
- **Governance:** obligations to treat policyholders fairly and specific requirements for market suitability assessments in the design of products and associated distribution plans

POLICYHOLDER ONBOARDING

The Code takes significant steps in relation to the protection of policyholders, especially around the point of sale.

Key Information Documents.

Much of the word count of the Code is concerned with the provision of Key Information Documents (**KIDs**) to prospective policyholders. In truth, the topic of KIDs could sustain a reasonably lengthy briefing in its own right, so what follows is simply an attempt to summarise the main points.

Anyone having even a passing familiarity with the prospective EU regime relating to packaged retail and insurance-based investment products (**PRIIPs**) will recognise these provisions of the Code as hailing from the same gene pool. The two regimes will probably end up coming into force at a similar time. The central idea is that prospective policyholders will receive a short (maximum 3 pages), readily digestible and non-sales orientated summary of the key provisions of the potential policy before they are bound. The requirements apply to all long term policies (other than "pure protection" policies, for which simpler requirements apply) and apply irrespective of whether it is written as intermediated or direct business.

The content of the KID is heavily prescribed and the scope for varying the layout or branding of the document is limited. One of the key areas where disclosure is mandated relates to charges, particularly commission payable to brokers, and the KID must include a clear explanation of the economic reality that any such commission that is paid by the insurer will, in point of fact, be financed from charges levied upon the policyholder.

The KID is separate from (and must not refer to) any marketing documents. It is also separate from the key contractual documents constituting the policy i.e. the policy conditions and policy schedule. Unlike the PRIIPs regime, the Code does not specify what would be the consequences for the contractual relationship between insurer and policyholder if the KID turned out to be inaccurate. An analysis of this would need to start with a consideration of misrepresentation remedies; clearly it seems unlikely that any provision of the policy conditions seeking to exclude liability for the contents of a KID would survive a challenge.

The KID must be provided in "good time before" the policyholder is bound. A KID is also required in the case of top-up premiums (but not contracted regular premiums), although in the case of top-ups the KID can follow "immediately after" the top-up. On inception of the policy, the KID must be signed by the policyholder by way of acknowledgement, but signature is not required in the case of top-ups.

For 2018, standard forms of KID may be used for each product, but from 2019 the KID must be tailored to the specific prospective policyholder and policy in question. The key distinction here is that – during the transitional period for 2018 – a generic disclosure of the maximum commission rate is permitted, but subsequently the rate applicable to the particular policy and policyholder must be set out in a tailored document.

The obligation to provide the KID lies with the insurer itself, not any broker or IFA.

Cooling Off and Cancellation Rights.

A prescribed point of disclosure in the KID is the existence of cancellation rights. The introduction of these rights is another important innovation within the Code. These rights apply to all long term contracts (including pure protection) and, like the requirement for a KID, cancellation rights apply irrespective of how the products are distributed.

In addition to referencing the cancellation rights in the KID, it seems that the insurer must also give the policyholder specific separate notice of the cancellation right. The cooling off period does not start until the contractual documentation has been delivered to the policyholder and runs for 30 days. The policyholder must only have posted his notice before the 30 day period expires in order to invoke the cancellation right. The

cancellation right also applies to top-ups (but only to the extent of the top-up, and not as regards the policy as a whole or any prior top-ups).

If the policyholder exercises the right to cancel, he is entitled to a refund of premiums. Provided it was properly disclosed in the KID and the cancellation notice, the insurer can deduct investment losses from realising assets, but no fees or commissions can be retained by the insurer.

Ongoing Disclosure.

In the past, once a policy was in force, the provision of information to the policyholder was purely a matter governed by the policy terms or, failing that, custom and practice. The Code seeks to address this situation. The Code simply refers in general terms to the provision of "adequate and appropriate information" and mention of specifics in the text is limited to corporate changes regarding the status and control of the insurer and changes to terms and conditions. But collateral guidance proposed by the IOMFSA goes into more detail on best practice for policy reporting. The guidance suggests full policy valuations and statements not less than annually, and at least quarterly for portfolio bonds.

BROKER ARRANGEMENTS

Unsurprisingly, given the focus upon broker sales commission in the template KID, the Code is also heavily concerned with regulating arrangements with intermediaries, referred to in the Code as "brokers". Essentially, this covers any intermediary, introducer, IFA or broker whom an insurer allows to "distribute" its products. It is not concerned with the insurer's own agents, but with those brokers who act as agent of a prospective policyholder. It should be assumed that, amongst other things, any broker from whom an insurer entertains an application for a policy, who holds any policy application forms or related documents of the insurer and any person to whom the insurer directs a commission payment will fall within these provisions of the Code.

The Code requires that the insurer have in place documented procedures for considering and granting terms of business to prospective brokers, including requiring a written application from the broker and undertaking a risk assessment. The Code also requires written terms of business including mandatory provisions relating to regulation, compliance with AML/CFT rules and dealing with policyholders.

For those brokers on existing terms of business that do not meet the criteria in the Code, the insurer has a grace period of 6 months to get compliant terms of business in place. Any new appointments of brokers from 1 January 2018 must be conducted in accordance with the procedures in the Code and must be made on terms complying with the mandatory terms. It seems unlikely that any insurers are still dealing with brokers without documented terms of business, but it seems that any such relationships will need to be formalised in accordance with the Code forthwith.

The Code requires an insurer to establish procedures to "regularly monitor" brokers to ensure that they remain "an appropriate distribution channel" and does not go into more detail. Proposed guidance from the IOMFSA provides some gloss. The guidance makes it clear that the frequency of reviews can be determined in accordance with a risk-based approach, but the scope of review includes a number of fields, some of which are potentially quite subjective in nature. In addition to matters of process, such as documentation standards, the review needs to cover - amongst other things - complaints, persistency and evidence of "churning". Departure from the guidance needs to be justified and documented by the management of the insurer.

GOVERNANCE

From the provisions of the Code described above, it can be seen that the new regime will necessitate an operational culture that gives more prominence to policyholder protection than has hitherto been prescribed by law. That alone will drive governance changes. In addition, the specific developments that have been summarised above do include related mandatory governance obligations:

- The requirement to regularly review the information contained in a KID
- The requirement for documented procedures for appointing brokers
- The requirement for regular monitoring of brokers.

Furthermore, the Code includes additional stand-alone governance obligations in relation to dealing with policyholders and as regards product design, marketing and distribution:

- A requirement to establish, document and implement policies and procedures for the fair treatment of policyholders as an integral part of an insurer's business and culture
- An obligation to review and update those policies and procedures
- A requirement to put in place product development oversight and governance arrangements to seek to minimise policyholder detriment, to manage conflicts of interest and to ensure policyholders' interests are taken into account
- A requirement, in designing products and identifying distribution channels, to identify the target market and tailor the product accordingly, to identify and manage mis-selling risks and to monitor distribution channels
- The IOMFSA is also issuing guidance on portfolio bond asset suitability and the use of discretionary portfolio managers (DPMs)

ACTIONS, DEADLINES AND TRANSITIONAL ARRANGEMENTS

Insurers should already have commenced preparations for the introduction of these requirements, which have been well-trailed. Assuming enactment in terms substantially the same as the latest draft, key initial steps for insurers to take include the following:

- Bringing any ongoing product development processes into compliance with the Code
- Reviewing the existing product range and distribution arrangements in light of the Code requirements and the guidance on portfolio bond asset suitability and DPMs
- Identifying any brokers without terms of business
- Preparing a template application form for brokers seeking terms of business
- Updating standard broker terms of business and rolling these out
- Reviewing policy conditions and assessing any Code implications
- Benchmarking current policyholder reporting arrangements against the new guidance

- Drafting template KIDs for each live product and deciding whether to avail of the option to use non-tailored KIDs during 2018
- Drafting template notices of cancellation rights and reviewing documents and procedures to minimise the down-side risks of policy cancellation
- Developing governance policies and procedures in the areas described in the foregoing section, including liaison between all affected business areas, with a view to documenting and approving at board level
- Embedding the monitoring and review of those policies and procedures within the corporate governance process and timetable

In terms of timings, the key dates for insurers to bear in mind are as follows:

1 January 2018:	Save as mentioned below, the Code comes into force and the guidance becomes applicable. Insurers need to comply with the Code, including the issue of standard KIDs (as a minimum), advising of policyholder cancellation rights and implementing the same, introducing broker appointment and review requirements and adhering to governance obligations. Crucially, insurers also need to be able to document that they are complying.
30 June 2018:	Deadline for all pre-existing brokers as at 1 January 2018 on non-compliant terms to be migrated onto Code-compliant terms of business.
1 January 2019:	Tailored KIDs required for all prospective policyholders.

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