REPORT OF THE EXPERT COMMITTEE

(on Brokers and Broker related issues)

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G.V.RAO	MEMBER
B.CHAKRABARTI	MEMBER
M RAMDOSS	MEMBER
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NOVEMBER 2006

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G K Raman,
Chairman,
Committee of Experts

November 14, 2006

Shri C S Rao
Chairman
Insurance Regulatory and Development Authority
Hyderabad

Dear Shri Rao,

Re: Report of the Expert Committee on Brokers and Broker Related Issues

In terms of your Order ADM/ORD/76/June –06 of the 19th July 2006, I have pleasure in submitting herewith the Committee's Report under the Terms of Reference given. The document containing the matters dealt with is divided in to three parts, namely,

(i) Executive Summary of major issues considered
(ii) The Detailed Report dealing with each Term of Reference, including the analysis of issues and the basis for the Recommendations made.
(iii) The detailed recommendations made by the Committee

1. The Committee has kept in view the overall purpose of constituting it viz., to consider the current Regulations in force governing the licensing of brokers, based on the experience of IRDA in the past three years; and how to strengthen the role of brokers in the context of de-tariffing, the current tariff structure of important segments of non-life insurance in the near future.

2. The introduction of brokers in the distribution channel from 2002 to represent the interests primarily of the insuring public is an important development in giving a role and a voice to it. As a wholesale buyer of insurance products, on behalf of several clients, the broker has an opportunity to restore the bargaining power of an individual insured with the professionals representing the insurers.

3. The imminent de-tariffing of important segments of fire, engineering and motor that represent over 70% of the market premiums is a very important challenge to the brokers, the consumers and the insurers. When the market is fully freed of the remaining tariff rating structures, it would also open up opportunities to the brokers for displaying their professional competence in better perception of risks and their management in prevention and minimization of losses.

4. The IRDA, with no previous market experience with the broking channel in India, has boldly brought in regulations in 2002 to give the brokers a start, despite a predominantly tariff market that has questioned the value addition of brokers to the insurance deals.

5. The Committee has endeavoured to reconcile the conflicting interests expressed before it by the various stakeholders, whose perceptions of the issues was primarily in self-interest. The interests of the consumers and the future development of the market in a disciplined and orderly manner have been kept as the major priorities by the Committee in assessing and evaluating the views expressed.

6. My colleagues, Shri G V Rao, Shri M Ramadoss, Shri S V.Samant and Shri B Chakrabarti have made outstanding contributions in the discussions with the stakeholders and in our deliberations in arriving at our final views.

7. Special thanks to my colleague Shri G V Rao, who has given his time liberally in collecting the background information and providing the Committee with his valuable analysis on various issues. He has also accepted the responsibility for producing the draft report that has facilitated the preparation of the final report.

8. Messers M. M Siddiqui and Mr. Suresh Mathur have provided excellent support services and in arranging our meetings with the various stakeholders at all the metros. They deserve our sincere thanks for all the help received by the Committee.

9. The Committee would provide clarifications and further information, as needed, if any point made in the report requires more elaboration by the IRDA.

10. In conclusion, we thank you, Mr. Chairman, for giving us an opportunity to be a part of this important exercise at this point of time.

With best regards,

Yours sincerely,

G K Raman
Chairman,
Committee of Experts.

Acknowledgements

At the outset, the Expert Committee thanks the Chairman, IRDA for providing the Members of the Committee an opportunity to review the Regulations governing the operation of Brokers and to suggest recommendations to strengthen the role of brokers particularly, in the context of the de-tariffing of non-life insurance being proposed by the Authority.

The Committee would like to thank Mr.M.M.Siddiqui and Mr Suresh Mathur of IRDA for the excellent support services provided by them in arranging meetings with various stakeholders at all the Metros.

The Committee places on record its appreciation and thanks to all the persons, Corporates, Associations and Trade Bodies that have so generously given their time and shared their view points with the Committee at several Meetings, both in person and also through emails and letters.

The Committee would like to thank Mr G.V.Rao who has given his time and efforts in collecting the background information and providing the Committee with valuable analysis on various issues. He also accepted the responsibility of producing the first draft of the Report which facilitated and helped in the completion of this Report.

Finally, the Expert Committee wishes to acknowledge the help, assistance and co-operation it received from various sources in the preparation of this Report.

An Executive Summary of Issues

The Brokers Regulations were issued in October 2002. It has 41 Regulatory sections that deal with all aspects of their licensing, functioning and responsibilities. There is also a prescribed code of conduct consisting of 15 provisions to govern the business conduct of the brokers with various parties. The compliance with both of them by the brokers is mandatory.

Major thrust of the report:

The two main issues that the Committee has been entrusted with, under the Order of 19th July 2006 of the IRDA relate (i) to the review of the current Regulations governing the licensing of the brokers based on the past experience of the Authority and (ii) to make recommendations on how to strengthen the role of brokers in view of the impending de-tariffing of non-life insurance segments that are now under tariff***.***

Context of the Terms of reference:

The Terms of Reference that guide such a review cover, in addition to reviewing the current status and contribution of the brokers to the market, (i) the corporate governance of brokers, and prevention of conflict of interest, if any, with other regulated activities (ii) financial viability and adequacy of the existing capital requirements (iii) the role of brokers as claims consultants (iv) the levels of brokerage that can be considered as fair in a total de-tariffed environment (v) the desirability to continue with the current licensing of Composite Brokers and (vi) the steps to be taken by the Authority to ensure effective supervision of broking activities.

The developments in the broking profession since the broking regulations were introduced in 2002, the adequacy of brokerage houses in terms of numbers and geographical spread to cover the whole country and the professionalism the brokers have displayed till now have also been dealt with, as a part of the Terms of Reference given to the Committee.

The Committee has made its recommendations keeping in view the impending de-tarffing of the remaining segments of business currently under tariff. How the consumer would benefit if this important distribution channel that primarily represents the consumers is strengthened to play a pro-active role. The broking community should be able to match the professional capabilities in terms of expertise, knowledge and negotiating skills with the long-practicing and long entrenched insurers, who have had direct customer relationships till recently. The brokers are required to define and perform their professional roles that all, including the insurers, would appreciate as beneficial to the entire market.

Licensing of brokers:

The licensing of the brokers and their entry norms in this context are important. The issuance of a license to a broker is governed under section 42 D of the Insurance Act 1938. The manner in which the license is to be issued is to be determined by the Regulations made by the Authority. But the section 42 D also prescribes a series of disqualifications that would disentitle an individual or a body corporate, as the case may be, from acting as an intermediary. In the case of a company or firm, its directors or partners should not suffer from any of the prescribed disqualifications.

Sub-section 5 (e) of 42 D refers to the disqualification as:" if he does not possess the requisite qualifications and practical training…. as may be specified by the Authority in this behalf". Training could also mean having had practical training in an insurance job in some recognized professional capacity for a minimum period.

Sub-section 5 (f) details an additional disqualification as that if "he has not passed such examinations as may be specified by the Regulations made by the Authority" the applicant is disqualified. This disqualification is also applicable to the directors of a company and to the partners of a firm under 42 1 (b). But as no examination has been specified for the directors to pass under the current regulations made by the Authority, presently, it is not necessary for any partner of a firm or a director of a company to pass any broker examination. Hence no disqualification applies to them now.

Sub-section 5 (f) is also anticipatory in that the Authority may, at some point of time, in the future prescribe an examination for the directors or partners, as the case may be, to pass such an examination to become eligible applicants for their licensing as intermediaries. The Authority is empowered to prescribe eligibility qualification norms in the form of passing an examination.

The question that has been considered by the Committee is whether, in the light of the past experience of the IRDA in licensing the brokers, the time has come for the IRDA to prescribe a qualifying examination for the directors or partners too to pass. The Committee has considered this issue in detail, after examining the current statutory provisions enabling the Authority to do so, the international practices in the UK in respect of brokers and what is desirable and necessary in the interests of the future of the market

Strengthening the role of the broker:

One of the other directions given by the IRDA to the Committee was to suggest ways of how to strengthen the professional role of the broking entities in a tariff-free market. Enhanced professional capabilities and expertise of the broking entities can only be acquired through acquiring recognized insurance-related professional qualifications to start with, and then to continually undergo training to obtain expertise through experience.

The broking entities today are not required to possess either of them to be licensed. The Committee has examined this issue, from the point of view of strengthening the role of broking entities to develop into a first-rate professional body of experts and made its recommendations.

Composite brokers licensing:

Continuing with the licensing of Composite Brokers was another issue that the Committee was asked to examine and to make its recommendations on the desirability of continuance of the system. It has discussed this issue with many participants that met us. The Committee has also looked at other features of their working and the responsibilities they shoulder. Its recommendations form a part of this report.

Brokers as 'claims consultants':

The IBAI and other brokers pleaded that the current restriction, 7 (e) of the code of conduct, on their taking up work as claims consultant on policies, not serviced by them needs to be re-examined, with sufficient safeguards built-in. The purpose of incorporating the restriction was perhaps to discourage unhealthy competition among the brokers themselves. The issues of 'claims consultancy' in respect of policies not serviced through them, along with the remuneration payable to the brokers by insurers in the new tariff-free environment, have been dealt with in the report.

Remuneration to brokers:

The code of conduct provision 11 describes matters about receipt of remuneration a broker is entitled to charge from his client. These provisos permit the broker to charge separate remuneration, fee or charges from the client on claims realization and for any other related services, rendered to the client, so long as this information and intention is communicated in writing to the client in advance of engaging his services.

Regulation 19 also prescribes the remuneration payable by an insurer for the broker's 'arrangement of the contract of insurance' of the particular business. The issues raised are: should a broker charge his client additionally for services that form a part of his functions, described under the regulations? Should he receive only the brokerage, and nothing else on the transaction even from his client?

There is an apparent contradiction in the relevant provisos detailed above, according to some. But it seems clear to the Committee that while the regulation 19 is applicable to insurers, the code of conduct provisions on remuneration apply only between the broker and his client. Describing a function to be performed by a broker in general terms, does not amount to having dealt with the payment to be made for additional services rendered by a broker to his client. If there is any ambiguity, in these two provisos, of what kinds of

remuneration a broker is entitled to, this should be clarified to remove the misgivings, if any, in the minds of a few brokers and any others.

One of the terms of reference given to the Committee relates to the remuneration payable by an insurer to the direct brokers in the event the market, as a whole becomes tariff-free. The response to this matter takes into account the various professional avenues that may be made available to the brokers to render quality professional services to the clients and to the market. These issues have been dealt with in the Report.

Financial Viability of broking companies:

Section 42 (E) (2) enables the Authority to prescribe the requirements of capital and form of business for an intermediary. The Authority has prescribed the criteria for various categories of brokers through Regulation

The reasons for prescribing the minimum paid-up capital requirements for licensing each category of broking entities, the Committee believes, was basically to ensure their financial viability in the initial stages of setting up of the brokerage house. However, as the Regulations do not specifically deal with taking the prior approval of the Authority for brokers to open new branch offices, the broking firm's subsequent expansion of offices would have stretched the current capital strength to its limit, and may be beyond all reasonable limits.

It is also understood that the provisions in the Memorandum & Articles of Association that brokers file before the IRDA, enable them to open franchises, sub-broking offices; and agency arrangements that are all catalogued, as subsidiary objects to the main object. Having permitted filing such a document, along with an application for a broker's license, should a broker be penalized, if he implemented, what has been made known in advance to the IRDA? The IRDA needs to look at this issue.

Training costs:

As regards the costs incurred for training brokers, several brokers have complained about the high costs incurred by them to train and acquire qualified staff, as it is mandatory for them to send staff for 100 hours of training that costs upwards of Rs 50,000 for each trainee. The purpose of training for 100 hours is to enable a broker to pass the examination. This imposition of 100 hours of training is proving a hurdle for brokers in the recruitment of qualified staff.

Brokers have represented to the Committee that since the purpose of the 100 hours of training is to enable a trainee to acquire sufficient knowledge and skills only to pass the broker examination, they could undertake the task of training them either themselves or ask the trainee to train on his own.

Also, there are several qualified insurance professionals with several years of experience on the job available for recruitment; but their compulsory training costs are so high that none is prepared to incur them. It is a case of availability of abundant talent but the inherent inability to tap it due to the high costs of 100 hours of training. Many ex-insurance employees could be attracted to the broking profession, as potential employees, if the training requirement is done away with.

It is argued that since the final criterion is the pass in the examination, the training could be dispensed with; it was suggested to make the brokers' examination more technical and more stringent to attract better insurance professionals than what the present system produces. This would also enhance improved professionalism of brokers at the entry point.

Reporting forms and effective supervision:
Monitoring the brokers' performance, their business practices, their compliance with the Regulations and the code of conduct, accounting standards and reporting, their internal control systems and the role the IBAI has played have all been considered in the report in detail and recommendations made in the report.

Any other appropriate issues:
The issues concerning the reimbursement of service taxes to the brokers, the Professional Indemnity policy coverage, the raising of foreign equity for brokerage licensing, and the insurers' reciprocal obligation of utmost good faith to provide financial and other information to consumers and brokers have also been dealt with in the report.

Life Insurance & Brokers:
The Terms of reference and the Order of the 19th July 2006 given by the Authority to the Committee suggested that the review to be undertaken by it was to be based on the current Regulations governing the licensing of Brokers and the strengthening of the role of brokers in the context of de-tariffing of non-life insurance proposed by the Authority. The members of the Committee appointed are all experts from the non-life industry. Hence, this report and recommendations made herein apply to the brokers currently functioning in the non-life industry. No aspect of life insurance business has been touched upon in this report.

Term of reference 1:

1. Review the developments in the broking profession since introduction of Brokers Regulations 2002.

The regulations and the provisions of the code of conduct for licensed brokers have remained in tact, since their enactment in 2002, without any amendments, The remuneration payable to the brokers was the subject of a study by the Expert Committee, constituted by the Authority in September 2003 under the Chairmanship of Mr. A .C. Mukherji. The Authority had, after the receipt of this report, revised the brokerage remuneration twice, particularly in respect of corporate accounts and in respect of their fire and engineering tariff businesses, through issuance of circulars.

The IBAI has informed the committee that 'the progress (for brokers) has been below expectations'. They assign several reasons for it but the primary one according to them is that 'broking was a new venture to the market' Tariff continuance, lack of experience, activities of other distribution channels, direct marketing by insurers, the offer of 5 % special discount to a few corporate houses and the general lack of awareness by the public of insurance products have also been cited for the limited progress.

The IBAI has informed us that, based on the information collected from the financial statements of insurers, a brokerage remuneration of Rs 122 crores in 2004/05 has been received. The brokerage income of Rs 122 crores that has been received, within two years of introducing the new distribution channel, in our view, is not an insubstantial progress at all. The expected capital invested by about 222 brokers (a year ago there were fewer brokers than 222) could be estimated at about Rs 170 crores or less.

That the brokers have been able to garner, according to their own estimates, such an impressive brokerage income, and particularly in a predominantly a tariff environment and with the other constraints they have cited, should be regarded as a success of regulatory intervention in introducing them in to the system. In a fully non-tariff environment, their role and consequential prospects of higher earnings seem even brighter.

Strength:

The broking community has grown in significant numbers. There are 222 licensed Brokers today, according to one estimate.. The direct brokers number 193, with reinsurance brokers 4 and composite brokers 25.

A majority of the brokers are based in the Western zone and number 79; and in the Northern Zone they number 78. The Southern zone has 47 brokers and the Eastern zone 18 brokers. There is, however, no licensed broker representation hailing from the States of Goa, Madhya Pradesh. Jammu & Kashmir, Haryana, Himachal Pradesh, Uttaranchal,

Bihar, Jharkand and Orissa, all the Northeastern States and Pondicherry, rendering the broking activities unevenly spread. The lack of representation of licensed brokers from so many States in India is glaring.

This could be due to several factors; the large amount of minimum paid-up capital required, the lack of entrepreneurship of locals, the inadequate availability of insurance potential, the proximity of metros to a few of the States, the expansion of licensed broker offices through opening of branches, franchising arrangements and sub-broking.

Financial and business activities:

The annual brokerage remuneration earned by each broker and by the entire brokerage community is not available. It is neither reported nor collected by any source, making the current broking activities less transparent. The IBAI, the body to which, all the licensed brokers should compulsorily offer affiliation as members, has no record of how each broker has performed. In fact, a few brokers asked the Committee to have this information in terms of business placed and brokerage earned to be published by the IBAI or the IRDA. There seems a considerable communication gap between the IBAI and quite a few of its members.

The IBAI has given us information that the total brokerage remuneration for all the brokerage members in 2004/05 was about Rs 122 crores. The source for this information, according to it, was the information published in the financial statements of the individual insurers. The information about the brokerage received for the previous year was not available from any source. How much of this remuneration was from reinsurance broking and from direct broking was also not available.

It is understood, from another source, that in 2004/5 a business of Rs 2500/Rs 3000 crores was placed by Brokers. How much of such business is from the corporate, the retail and the rural segments is not available. The contribution made by the brokers to the development of the insurance profession and the industry is not available. Currently, brokers are required to provide details of their major sources of income at the time of renewal of licenses only.

The Committee also understands that routine inspections of broker accounts have not been conducted by the IRDA, except in a few cases, when specific complaints were received against a few of them. The IRDA, it is understood, is currently engaged in developing on-line data collection module but the system is yet to take off. The annual accounts that are now filed with the IRDA, do not disclose the full particulars of all their financial and business activities.

In the absence of published data on brokers' activities and their business functioning from any source, it has not been possible for the Committee to review the developments of the broking profession except in generalities.

It is also understood that quite a few brokers have opened branches or entered into franchise arrangements with other bodies, as, currently, there is no regulatory requirement to seek the Authority's permission for it. It is also not clear, if qualified professional brokers, as required by the regulations, are manning such offices. It was reported that a few brokers also act as "servicing arms" of insurers by issuing policies and cover notes and get remunerated additionally from insurers in violation of the regulations, under "binding authority' given by insurers.

Lack of a verification process, to ensure that they follow broker regulations, has emboldened them to act without scrutiny, interference and questioning. In fact, the broking profession has largely been left to its own devices to practice self-regulation. Reports of unethical practices of rebating and kickbacks are touted but in the absence of evidence, it has not been possible to comment on these allegations.

Role of IBAI:

The role of the IBAI needs re-examination, particularly as the IRDA has insisted that all brokers must be its members under the code of conduct provision 3 in respect of its sales practices. There is a reference to a MOU therein with the IRDA. No such MOU was available for our examination.

The code of conduct provision 3 also stipulates that the brokers should confirm that they do not employ agents or canvassers to bring in business. The provision does not say who should receive this confirmation and the form and the periodicity. The code of conduct provision 1 stipulates that in its clients' relationship the brokers should avoid a conflict of interest. The licensing of composite brokers does seem to be in variance with this stipulation.

It is inferred that it is largely for the IBAI to ensure that the code of conduct provisions are strictly observed by its entire member brokers, as the membership of the IBAI is compulsory. This objective, if it was intended, does not seem to have been fulfilled. The role of the IBAI as expected by the IRDA, and as performed by the former, needs to be redefined, fixing specific accountability norms of self-regulation.

- **The Committee recommends that IRDA may streamline its *data collection process* and have its *internal machinery to review the business and financial activities of each broker*, once a year, with respect to the fulfillment of regulations. Elsewhere, the Committee has also made recommendations that the statutory auditors of brokers' accounts must be held accountable.**

- **The IRDA should have its *inspection machinery, either internal or outsourced, to conduct inspections periodically*. A licensed broker should be inspected at least once in three years, as a matter of routine. A few of the current wrong business practices that have crept in are due to the absence of the inspection mechanism. In a non-tariff and free market, the *inter se* competition among the brokers and among the insurers is likely to heighten than diminish. Without investigative machinery the wrong practices could multiply.**

- **The IRDA should also consider drawing up either on its own or in consultation with the *ICAI 'Accounting Standards'* for certification of broker accounts that the statutory auditors must follow.**

- **The brokers (who are all private limited companies, with the exception of one) must be asked to furnish detailed annual *"Management Reports" to accompany their annual financial statements* that should give a list of particulars that IRDA should outline. The Auditor should be asked to certify the accuracy of the statements made in the "Management Report". The number and names of offices, the income generated from each source, the quantum of portfolio business acquisition, the income split up from each, the details of sources of other types of income and the names of qualified officials working in each branch should form a part of the "Management Report".**

- **The role assigned to the IBAI in the code of conduct provisions, as a self-regulatory body, needs more clarity with defined accountability.**

<u>Term of reference 2</u>

2. Review the business practices in broking with particular reference to the adequacy of the existing number of brokers for promoting healthy competition:

The Committee has already referred, under the Term of reference 1, that several Indian States do not have broker representation. Considering that broking has been introduced only in 2002 and that too in an industry environment that is predominantly a tariff dominated one, wherein the Brokers have had no opportunities to demonstrate their

professional expertise, knowledge and negotiating skills, it is too early to make a reasoned evaluation of their utility in numbers to the market.

According to the Committee, the real issue to be addressed is whether the broker community, as of now, has attracted persons of proven professional competence, insurance expertise and ethical conduct in to its fold. There has been no feedback to the Committee from any source on this issue. Very few client groups have sought meetings with the Committee to express their views on the contribution of brokers. Those that did, while appreciating the role of the brokers, did not have much to say on their contributions.

Perhaps the prevalence of the tariff environment was a major reason, why the clients could not make demands on the brokers for the latter to comply with them. For a few new insurers, that want to contain the costs of branch expansion, the brokers have served as a marketing and servicing arm.

It is reported that a few brokers have opened a number of branches, without regard to the adequacy of working capital requirements, and without ensuring the availability of qualified and trained manpower at such offices. It was also reported that franchise arrangements and sub-broking practices have already been brought in. A few brokers are also working as agents of insurers, under a binding authority to issue policies and service customers, for which insurers pay them remuneration. These business practices have crept in, and growing in number, as there is no verification mechanism of what these brokers are up to.

The functions, the role, the duties and responsibilities of brokers can be regulated, as they are now; but the high professional and ethical standards required in a free market are to be set by the brokers themselves. The tariff environment has made many brokers look at returns on their investments, and how to achieve higher brokerage incomes than on what they could professionally contribute to their customers and the market. It is the mindset of the brokers, whether they would want to conduct themselves professionally or commercially, that would determine the quality of their contributions. It is expected that in a non-tariff environment they would conduct themselves, more responsibly. But the current signs are not promising, as the brokers' goal so far has been to expand their brokerage income.

Current norms of entry:

The injection of professionalism and the mindset for implementing acceptable best practices among the brokers must start at the entry point. The entry into the broking profession has been regulated, based more on the threshold of the minimum paid-up capital norm of Rs 50 lakhs for a direct broker (it varies for other types of brokers) than on any professional insurance qualification or expertise of the personnel that form the broking firm.

Any individual, or a group of individuals, can form a company, irrespective of his professional insurance credentials and is then eligible to apply for a brokers' license, so long as Rs 50 lakhs can be raised. The only other criterion of eligibility required for a broking license is the appointment of an employee, who is a graduate, and who has undergone 100 hours of training and passed a qualifying examination. The professional profiles of persons that enter the broking profession are given less or no importance at all in the licensing norms. This needs to be corrected. Separate recommendations have been made on this issue.

On both the above counts, the Committee is of the view that the current eligibility criteria to get broking licenses are less stringent. Whether such a broking firm, as the legal representative of the insured, would function as a truly professional one with capabilities of insurance knowledge and expertise to match or deal, as an equal with the professionals with decades of experience in an insurance company is arguable.

Business practices:

Such easy entry norms would have perhaps encouraged non-insurance professionals to enter the profession, persons that view broking, as a business worth investing in. With commercial instincts, rather than professional capabilities, guiding the broking business of the firm, it is likely that the available opportunities for unethical practices of kickbacks to creep in are quite high.

Another reason attributed for the likely demand for kickbacks is that the current remuneration structure, lends itself to unethical customers asking them for a share in it, on the ground that no value addition has been brought in by the broker, who is arguably not a professional with proven expertise; and that the percentage quantum too is high.

The brokers, in the view of the Committee, suffer from a disadvantage at present that the consumers do not adequately appreciate the professional capabilities and inherent talents of the brokers. How professional the brokers would be in a fully non-tariff environment that would impose risk management capabilities and negotiating skills of the highest order on them is yet to be seen.

The major issue of concern is not the adequacy of brokers in the market today but the quality level of the professional expertise required for the future, in a non-tariff environment. This issue can only be dealt with by making entry norms for brokers to be based more on the stringency of proven insurance qualifications, expertise and experience rather than relying only on the minimum paid-up capital norm.

When the broking license norms are examined in this context, in respect of Reinsurance and Composite Brokers, the professional inadequacies become more glaring. As these types of brokers, however, deal with professional insurers that know their business, the equation could be on an almost equal professional footing. But in case of clients that need direct insurance, the direct brokers have to deal with very knowledgeable and experienced insurance professionals. Would the brokers, lacking in comparative competence, get the best coverage at reasonable rates for their clients? The knowledge gap between the two is likely to bring in and promote unethical practices. The persons that enter and operate the broking profession need to be professionally qualified and experienced. The Committee has made separate recommendations on this issue.

As far as the matter of healthy competition is concerned, there is hardly any scope now in the tariff environment for brokers to display or leverage their professional capabilities. With detariffing of the market, next year, it is expected that brokers would find opportunities to show off their professional skills and expertise.

The Committee is of the view that the current strength of brokers is not adequate, considering that the market needs more brokers in a non-tariff environment. The broker representation, geographically, is unevenly spread.

<u>Term of reference 3:</u>

3. Review the level of professionalism in business and recommend further measures to enhance and promote the same:

The brokers, as pointed out earlier, have been currently constrained to display any aspect of their professionalism in the tariff environment. They are now driven mainly with the objective of acquiring sufficient brokerage incomes than attempting to raise the levels of their professional standards. The brokers seem disappointed that their brokerage incomes are below their expectations.

But the real question is: do they now have the professional talent within them that would find an expression later in the non-tariff environment? What is the current broker professional profile in respect of their knowledge levels in insurance, experience, expertise and skills? Herein lies the gap between the current state of affairs and what is likely to be needed in future.

There is nothing tangible seen of the efforts made either by the brokers on their own initiative or by the Authority by compelling the brokers to pass higher levels of insurance examinations to raise the brokers' professional talent. The entry-level standards seem sufficient and good enough even at the time of renewal of brokers' licenses. Renewal of broking licenses is an opportunity to impose improved professional standards on the

brokers, without which they have little incentive to improve on their own. Renewal of licenses should be done based on the brokers having shown the Authority that their insurance brokers are better qualified than earlier.

For the present, the brokers are concerned more with protecting their invested capital and wanting to raise their brokerage revenues, quickly: particularly as the market has been ‘hostile’ to their entry. As new entrants, they are unwanted by most stakeholders; their difficulties are compounded due to the market being a tariff one.

Opening new offices:

Quite a few brokers, it is reported, have opened several types of offices because of the ‘missing links’ in the regulations in respect of opening up of new branches, without IRDA approval and without having the professional manpower needed at all centers. It is reported that a few of them operate as brokers for the insured and also act as ”agents’ of insurance companies, by signing policy documents, for which they are paid separate remuneration. The insurers too are reported to be collaborative partners in diluting the professional standards of the brokers.

The nature of insurance business is such that legal standards alone are not sufficient to encourage professionalism in the industry. It is more a matter of ethical conduct and mindset and self-regulation at the level of brokers themselves that can bring in higher professional standards. It has to be self-motivated. This is unlikely to happen. The only deterrent against unethical conduct is a monitoring mechanism to ensure that breaches are detected quickly and the levels of punishment imposed severe. Professional standards, in the current environment, have to be enforced.

The example in US of brokerage firms being targeted by the New York Attorney –General to cleanse the broking system of illegal and wrongdoing practices is the latest example that no society or market can say that without the watchful eye of authorities, the competitive model would work for the benefit of all stakeholders, particularly the consumers that finance the revenues of the insurance industry.

The reinsurance broking is another area that operates across national borders, occasionally cutting out the insurer, and zeroing in directly on the customer: as though they are the direct brokers. In a few cases, they do act as direct brokers, as composite broking is permitted. A composite broker then becomes primarily a broker for the insured; and later on for the same transaction, he acts secondarily, as a reinsurance broker for the insurer, thereby collecting two brokerage commissions for the same transaction. Such activities are unprofessional and unethical, in addition to being questionable under common law. This conflict of interest situation has been dealt with elsewhere in the report.

With more MNC contractors winning manufacturing and infrastructure building work contracts in India, there is an increasing tendency for the MNCs to look for Composite brokers, who would look out for insurers, who would act as 'fronts' for a fronting fee. There is no legal bar for them in the present regulatory environment to get two-broking fees for one total transaction and neither is 'fronting' defined.

Hopefully, freeing the market of tariff price controls would give the brokers an opportunity to display their professional wares that they claim they have. But ultimately, in any market, the professional standards can be raised only if the consumers make tough demands for improved services, and if there exists fair competition for excellence among the brokers themselves and if the insurers' are able to manage the high expectations of the consumers and the brokers by their professional expertise and ethical conduct. Would such a situation develop in the non-life market in India? Every stakeholder expects IRDA to impose professional standards on them than attempting to practice such standards on their own.

As of now, none of the stakeholders has displayed any initiative to respond to enhancing the demands for higher professional and ethical standards. The lack of consumer interest in making demands on the market players to raise their professional and ethical standards is disappointing.. This aspect needs the attention of all stakeholders so as to get more customer participation in their activities. Hopefully, the freeing of the market of price controls would do that.

As far as the enhancement of broker professionalism is concerned, higher standards have to be set only by the Authority, as there is little inclination for the brokers to set them up on their own. Periodic inspection of broker accounts on their business and market conduct activities is the only verifiable mechanism to understand the standards practiced by a majority of them. Ethical conduct to be practiced as a matter of tradition rather than as a legal requirement has to be encouraged. This is more a matter of mindset than enforcement. This comment applies equally to the insurers as well.

Term of Reference 4:

4. " Review the adequacy of the Brokers Regulations and Code of conduct for the Brokers and make recommendations for improvement thereof with particular reference to: (various issues numbered under (a) to (h).

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The Committee has been asked to review the current broker regulations and the prescribed code of conduct based on their current broking practices and activities. The principal idea behind such a review, and the recommendations to be made thereafter, is how to strengthen the role of the brokers in the future scenario. The Committee recognizes that the brokers, as the agents of the insured, have an even more important role to play in the future to equalize the bargaining and negotiating power between a buyer of insurance,

who is ignorant of the technicalities of insurance and what determines their pricing structures and the highly regarded professionals of insurance providers.

Term of reference 4 (a):

(a) Corporate Governance of brokers and prevention of conflict of interest:

The first section under this term of reference deals with the issue of corporate governance of brokers. The Committee understands that, with the exception of one broker who is an individual, all the remaining licensed brokers of 221 are bodies corporate. Since almost all of them are bodies corporate, their standards of corporate governance have a strong impact on their market conduct on the observance of several regulations and their code of conduct.

For licensing a broker including a body corporate, the prescribed current regulation 9 (2) (A) prescribes the following: (A) Whether the applicant is not suffering from any of the disqualifications specified under sub-section (5) of the section 42 D of the Act (B) whether the applicant has the necessary infrastructure…. (C) Whether he has in his employment a minimum of two persons (qualified as prescribed) (E) Whether the applicant fulfils the capital requirements (F) whether the Principal Officer has prescribed minimum qualifications (H) that the applicant is not engaged in any other business other than main objects of the applicant.

The sub-section (2) (b) of section 42 D of the Insurance Act 1938 states that (while granting a license to an intermediary) " in the case of a company or firm, any of its directors or partners does not suffer from any of the disqualifications". Sub-section 5 (e) specifies these disqualifications as: that he does not possess the requisite qualifications and practical training for a period not exceeding 12 months, as may be specified by the regulations to be made by the Authority" and the disqualification specified in 5 (f) states that " he has not passed such examination as may be specified by the regulations to be made by the Authority".

When a body corporate is granted a broker's license, the disqualifications referred to above, in our view, would apply to all directors or partners, as the case may be. The import of sub-sections 5 (e) and (f) of section 42 D, therefore, is required to be re-examined and its applicability re-evaluated. The Authority has powers to specify the requisite qualifications and practical training, and also has powers to specify what examinations the directors or partners need to pass. Whether only the Principal Officer, who may be only an employee, has to pass the prescribed examination, as at present, or all the directors or partners should do so, has to be determined. The import of 'practical training' under 5 (e) has also to be described to what it refers.

Assuming that the Authority has duly considered these issues already, prior to prescribing the current regulations for licensing, the Committee proceeds with its report of what is desirable for the future.

The Committee wishes to point out that the broking activities would involve two important and key aspects of registration: one is that of licensing the broking firm itself and the other is the accreditation of the qualified individual broker attached to it, as a professional practicing broker to solicit, canvass and place insurance business.

In licensing a body corporate, as the recognized licensed holder / broker, the Authority is recognizing the legality of the license having been given to the body corporate that is responsible for compliance of all the regulations and the code of conduct made. But having done so, the Authority seems to rely solely on the Principal Officer, a paid employee, as accountable to it for implementation of these provisos. There is an inherent conflict in evaluating the specific responsibilities and obligations of these two entities viz. the boards of the body corporate and the Principal Officer. In usual parlance it is the license holder that ought to be responsible for discharging the expected obligations to the insuring public under the regulations made. As such there is a need to redefine the entry norms for body corporate brokers.

In the UK, the Insurance Brokers (Registration) Act 1977 provides for (i) setting up the ***Insurance Brokers Registration*** Council. There are two types of registration of brokers. Individuals who are entitled to be registered as Insurance brokers by the Brokers' council if a person satisfies the council that he has the necessary prescribed qualifications and experience. Adequate practical experience is also stressed.

The rules for registration of brokers in the UK stipulate that in respect of registration of a body corporate, it is entitled to be enrolled as an Insurance broker, only if it has a majority of its directors as registered insurance brokers; or if there is only one director that he is a registered insurance broker; and where there are two directors, one of them is a registered insurance broker and the business is carried on under his management. There are separate provisions regarding the entitlement qualifications for registration of insurance brokers.

The insurance brokers, mostly individuals, are enrolled as Insurance brokers in the "Register". The bodies corporate given broking licenses are enrolled in a "List". But the qualifications to be so enrolled are as above.

Even though the Regulations in UK are with FSA now, the previous Regulations have been followed for long years and hence worth following by our Country, which is in the nascent stage as far as Brokers are concerned.

In the Indian context, Section 42 D sub-sections 5 (e) and 5 (f) of the Insurance Act 1938 also empower the Authority to prescribe an examination that the directors or partners should pass, without which they can be disqualified from eligibility norms, as applicants for a broker's license. Under Regulation 9 (2) (A) that deal with consideration of the application for a broker's license it states that the Authority in particular, shall take into account that 'the applicant is not suffering from any of the disqualifications specified under sub-section (5) of the section 42 D of the Act'. The body corporate is covered in 42D 1 (b). One of the disqualifications is " that he has not passed such examination as may be specified in the regulations made by the Authority".

In view of these specific provisions 5 (e) and 5 (f) in the Insurance Act 1938 enabling the Authority to prescribe an examination for directors or partners to pass, and in view of the international practice in UK of registering the broking firms, only if a majority of its directors possessed broking registration license individually, the current licensing broking regulations and procedures practiced would need a review.

The Committee has dealt with this issue in detail, as it is one of the two major points it was asked to deliberate upon. Reviewing the current regulations governing the licensing of the brokers is one of them. The Committee has also been asked to suggest measure to improve the level of professionalism in the business. A broker, as one who represents the insured, must be professionally competent on equal terms with those technical experts engaged by the insurers. In the case of reinsurance broking, the level of professional competence, knowledge and expertise required is even of a higher order. As reinsurance brokers deal with complex risk of large values, it is all the more necessary that the body corporate that is licensed has directors that know the insurance and reinsurance business.

There is, therefore, a need for the Authority to ensure that the Promotee--Directors of an insurance broking firm are serious enough, business-wise to run it, as a professional broking company, with competence and with necessary insurance expertise. With regulatory inspection as the only means of detecting irregularities, there is a compelling necessity, in the free-market to ensure that a minimum number of the Directors of the broking company are knowledgeable in insurance technicalities and are ethical in their conduct and do behave as professional experts in their field, to the satisfaction of the Authority and the consumer public.

The broking body corporate needs to professionally distinguish itself, from the duties and responsibilities of its Principal Officer and the individual professional brokers the Board engages, as the former may be an employee but the latter is a corporate entity with a legal identity of its own.

The present position with regard to licensing the broking firm is: where the broking firm is a body corporate, it needs only to satisfy the Authority that its Principal Officer is a graduate, who has undergone 100 hours of training and passed the qualifying broker examination. It is also incumbent, in addition, that at least two persons, who are authorized to solicit and procure business for the broking firm, must be similarly qualified.

The IRDA provisions are silent on the issue of the insurance professional qualifications of the Directors of the broking firm, to whom the broking license is given. With the Board in effective charge of the firm's commercial and professional activities, and its staff responsible for its broking operational activities, there is a need to have an effective mechanism to harmonize these two separate responsibilities of direction and execution.

Status of other intermediary bodies corporate:
Statutory and regulatory requirements for bodies corporate in respect of surveyors' licensing are quite stringent. The statutory provision 64 U M (i) (D) of the Insurance Act 1938 is even more explicit. " *No license to act as a surveyor or loss assessor shall be issued unless----the applicant, where he is a company or firm, satisfies the* ***Authority that all his directors or partners, as the case may be, possess one or more of the qualifications specified in clause*** *(i) and none of such directors or partners suffer from any of the disqualifications mentioned in sub-section* ***(4)*** *of section 42****".*** Both qualifications as well as disqualifications have been prescribed for surveyors and loss assessors.

While the statutory provisions for surveyors are thus pro-active in that the directors must posses one or more of the qualifications specified therein, in the case on brokers as intermediaries the statutory provisions prescribe only the disqualifications for the directors that would disentitle them as broking applicants; and not what qualifications the directors of a body corporate should possess. The reasons for differing provisions between the two intermediaries are unclear. There is no reference to the qualifications of Directors of a body corporate at all in respect of brokers.

Whereas surveyors deal with loss assessments of a few lakhs in the industry, the brokers have the opportunity and authorization to deal with crores of customers. The purpose and intent of the statutory provision for surveyors seems clear: to make the directors of the company or partners of a firm responsible for the actions taken in the name of the respective bodies by the directors that constitute its legal face. In the case of brokers, being the legal agents of the customers, have even more onerous legal responsibilities to discharge, as bodies corporate.

The Committee, therefore, recommends that every insurance broking firm, seeking a broker license, which is a body corporate, must have at least one of its Directors to possess the qualifications that would qualify him to be licensed as individual

qualified registered insurance broker. In the case of an individual or a partnership firm, at least one of them should have acquired the qualifications to become a registered licensed broker in an individual capacity and the business is carried under his management. In addition, the Principal Officer must also be co-opted as a director on the body corporate. Thus there would be at least two directors possessing qualifications of licensed brokers.

The Authority needs to prescribe by regulation that at least one director of the body corporate must have passed the broker examination before it can be licensed. It should apply to all future applicants of broker licenses. The Principal Officer must also be co-opted as Director on the body corporate.

For those firms that have already been licensed, a suitable time frame, say of two years, may be given to have two of its Directors, including the Principal Officer, so qualified and accredited. This would lead to having higher standards of corporate governance and professionalism, best business practices to prevail, assist in developing a healthy competitive environment and an improved regulatory compliance.

Training, qualifications and examination:

All the participants have informed the Committee that the compulsory training of 100 hours for a broking official has acted as a big hurdle in getting adequate number of professionals in to broking profession. While all of them have stressed and agreed with the necessity to test the knowledge and skills of potential broking employees by insisting on their passing a qualifying examination to be conducted for them, compulsory training in recognized institutes should not be mandated. Freedom for self-study and enabling brokers to train them should be adequate. The final test is the pass in the qualifying examination without which no accreditation should be made.

The Committee believes that the basic objective of training professional brokers must be such, as to secure them adequate knowledge and skills for the practice of their profession. It was represented to it that the current costs of training charged by Institutes recognized by the IRDA are prohibitively costly. This has, in fact, hindered the brokers in their efforts to recruit qualified staff they badly need. 100 hours of training cannot turn out or shape up a respected broking professional. At present, even former senior executives of insurance firms, with high professional insurance qualifications and long years of experience have to absorb this training along side the insurance novices.

The basic purpose of the 100 hours of training is only to ensure transference of knowledge and broking skills. The proof of adequate learning and absorption of training is seen in the results of the examination. Since the end result is the pass in the examination, and training

is only a means to that end, and there are a number of less expensive ways to acquire the level of knowledge and skills, the compulsory training of 100 hours should not be loaded on any participant. In fact, the examination should be stricter in testing the degree of knowledge proficiency both in insurance /reinsurance and the appreciation of the regulations in force.

There are large numbers of active ex-insurance employees, who are currently available, who not only possess recognized qualifications in insurance but also have vast practical business experience. The present regulatory requirement insisting that even such highly qualified and experienced insurance professionals, and even the former CMDs, must undergo 100 hours of compulsory training in recognized Institutes is proving an obstacle in getting more qualified persons as brokers. This was the summation from several brokers and the Committee agrees with them.

A measure of relaxation in the provision of compulsory training of 100 hours, that has proven expensive, would reduce recruitment costs, and would encourage, in all likelihood, a massive inflow of professionally qualified and experienced insurance professionals into broking activities. A huge pool of such qualified and experienced insurance professionals to carry on broking activities can be created. This pool would give a massive boost to broking firms to employ persons from such a talent pool.

A recommendation has been made that the regulatory requirement of 100 hours of compulsory training be totally dispensed with, for all the aspiring professional brokers. An examination should be conducted by the Insurance Institute of India exclusively for all aspiring professional brokers, to be held quarterly or half-yearly, more stringent than the present examination, to test the adequacy of knowledge and skills that a professional broker needs at the market place. Those that pass the qualifying examination alone should be issued a certificate to practice by the III.

The syllabus that is now prescribed by the IRDA may be redrawn in consultation with National Insurance Academy and the Insurance Institute of India (III) from the syllabus in UK for Chartered Brokers. Such a syllabus must include the governing regulations and the code of conduct for brokers.

Common Directors on other regulated bodies:

There is currently no specific regulatory prohibition of one individual functioning as a director in a broking firm, a TPA firm, a Corporate Agency and a Surveyor firm. Since all these are commercial professional bodies, and as the Authority directly regulates them, it is necessary that suitable ethical standards are maintained by the directors to avoid any undue influence in the operations of one sector being brought to bear on another.

In the case of the broking activity, the regulations make it mandatory that the firm, it should include all its directors and partners, should not be engaged in any other business activity. The spirit behind this provision makes it clear that it should equally apply to other insurance business activities and such a measure must cover the directors as well.

The Committee recommends that there should not be a common director with a management responsibility for more than one regulated insurance business activity. A clarificatory circular may be issued to avoid any ambiguity.

Opening new broker offices for business:

The regulations have not contemplated what norms should apply to brokers opening additional offices. Every office opened needs additional capital to provide for infrastructure and to meet the costs of manpower. More over, the effective control and supervision of their activities by the Authority get diffused and obscure, if no prior approval for opening a new office were not taken. There is a need to infuse additional capital for every new office opened even after the Authority has approved its opening. The issue of additional capital is dealt with under minimum capital needs.

Apart from stretching the financial viability of the broking firm, if a broker opened additional offices, it is not clear if such a new office does have the professional expertise of two qualified brokers and has the availability of minimum infrastructure facilities. There is no apparent reason, why when insurers are asked to take prior approval of the Authority for opening new offices, brokers, at present, can do so without any let or hindrance. This differential needs to be bridged.

The Committee recommends that the opening of new office for business by a broker should be only with the prior approval of the IRDA, who may ensure that the prescribed additional capital for each such office, as recommended, has been injected and that the necessary professional and qualified manpower to run its new operations is available.

As far as the brokers, who have already opened additional offices, by whatever name they are called, the IRDA should direct them to report these new offices already in business to it; and should also ask them to come up to the new standards of additional capital prescribed for each office and the minimum manpower needs within a specified time frame. The matter relating to the quantum of injection of additional capital is dealt with later in the report.

Sub-broking:

Another issue raised vehemently by the IBAI at all forums was to permit the brokers to engage the services of sub-brokers for whom they would be responsible. The ostensible ground in making this demand was the excessive training costs the brokers have to incur, when they have to recruit their own paid staff. No evidence of any other developed market having successfully adopted the sub-broking concept/ model was given to the EC, though it was adduced as additional evidence in its favour.

They quote the SEBI example often on this topic. But the broker or the sub-broker in SEBI has duties, more in line of carrying out the specific instructions given by his Principal than one of having to professionally advise him of various available alternatives and guiding him finally of what alternative to choose from. A SEBI sub-broker's functions are different from an insurance broker. It is not the right example to be copied in insurance business, wherein a higher degree of professional competence, expertise and liabilities to consumers are involved.

Sub-broking also needs new regulations to be issued by the IRDA. The relationship between the two, between the broker and the sub-broker, is one of Principal and Agent and is fraught with legal implications from the point of privity of contract among the broker, the sub-broker and the consumer. Who is responsible to whom for liabilities? As such, the EC strongly discourages the institution of a new distribution channel in the current state of broking, which has yet to prove its professional credentials and make meaningful contributions in a non-tariff market.

Accounts furnishing:

The requirements on annual Financial Statement submissions are currently very simple. They do not cover all the details of the entire broking operations. It only provides the Authority information on its financial status, sans how the picture was actually arrived at.

The IBAI has quoted from the financial statements of the insurers that the brokers have derived about Rs 122 crores, as brokerage income last year. They had no additional brokerage details available with them. From what portfolios did this income come, and how much of it is reinsurance brokerage is not known.

The accounting records maintained and rendered to the Authority should be more detailed to show and explain the transactions of the business; the P/L account must be supplemented by statements showing the individual and total revenue streams of the business, dividing such revenue between amounts directly derived from insurance broking business and all other revenue; classifying expenditure grouped under appropriate headings and showing the total brokerage.

The ROI of brokers also needs to be monitored annually to ensure how expenditure is distributed and if such incurred expenditure is in line with its activities. The issue of "Kickbacks" has to be relentlessly monitored to ensure that neither the insurers nor the brokers are indulging in it.

Inspection of broking firms' accounts and activities by the Regulator periodically should be supplemented by professional third party certification, like the statutory auditors' reports, on areas of concern that might endanger their financial viability, and disciplined working, as per laid down regulations and code of conduct provisions. This step would ease the burden on IRDA, if auditors highlighted the areas of concern that needed quick remedial regulatory action.

The Committee recommends that the ICAI should be requested to suggest a set of accounting standards, from the point of view of financial disclosures and transparency standards, considering the important role the professional brokers would play in a free market of intermediaries.

The Statutory auditors of the broking firms should be asked to examine and comment on the efficacy, adequacy and quality of the internal audit systems of the brokers in place; and the action taken on its reports by their broking firm / directors. The statutory auditors should also be asked to examine and certify, if the brokers' regulations and the code of conduct provisions have been observed in full; and to report the breaches found, if any, in their Annual Reports.

<u>Term of reference 4 (b):</u>

4 (b) Financial viability of broking companies, adequacy of existing capital requirement and other prudential controls considered necessary to ensure continuing financial soundness of operations:

Under the current regulations, a minimum paid-up capital of Rs 50 lakhs has been prescribed for licensing a Direct Broking firm, Rs 2 crores for a Reinsurance Broking firm, and Rs 2.5 crores for a Composite broking firm, who combines the functions of the Direct and Reinsurance brokers. This is without reference to the place where the broking firm is headquartered.

There is nothing on record available to the Committee to infer, why the Authority has prescribed these specific minimum capital quantum structures as the threshold norms. One can only surmise that, among several other reasons, the threshold limit of capital is pitched, at the current levels to take into account the minimum capital required to equip the offices of a broker with IT connectivity, to enable him buy other office equipment, to incur office expenses such as rent and communication costs, to pay for manpower costs,

marketing costs etc. Since 20 percent of the minimum capital is tied up, as a fixed deposit in a Bank, only 80 percent of the paid-up capital is available to a broker to carry on his business operations on a sustained basis till he generates his brokerage income.

However, irrespective of the City or the State in which the broking firm is located, the minimum paid-up capital required is allowed at the same figure, as above. This has resulted in over 50 % of brokers aggregating in the insurance prosperous States of Maharashtra and New Delhi.

There are a number of States like Bihar, Jammu & Kashmir, Himachal Pradesh, Haryana, Uttaranchal and Jharkand, all the Northeastern States, Orissa, Goa and Pondicherry having no broking establishments at all. This trend is indicative perhaps of the inadequate insurance business potential available therein and the lack of entrepreneurship of the locals. This issue needs to be addressed to encourage the broking distribution channels to grow in the un-represented and under-represented States.

Brokers, in the absence of prior regulatory approval, to open their new offices, without having to enhance their current paid-up capital structure have expanded their activities. The IRDA must perhaps have the information, through the disclosures in the financial statements filed by the brokers, about the number of offices opened by each broker, without having to raise the capital and without informing the availability of number of qualified soliciting brokers. In one instance, one broker, representing a major industrial group informed the EC that it has over 200 employees. Thus, an effective mechanism to monitor the continued financial viability of each broker at all times needs to be put in place.

This makes the prescribed minimum paid-up capital norms for brokers seem elastic enough to serve the expansionist, ambitious needs of a few brokers. With the exception of the IBAI, who wanted the paid-up capital norms to be reduced, almost all the submissions received by the Committee have asked the paid-up capital norms to be significantly raised, even without the benefit of the above analysis.

Suggested Recommendations:

- **The Committee recommends that the current minimum paid-up capital norms to start new broking operations be based on the status of the City in which the broking firm is headquartered. The Metros should have a minimum paid-up capital Rs 50 lakhs; State capitals Rs 40 lakhs and at all other centers Rs 30 lakhs.**

- **The minimum additional capital for each new branch office to be opened by the broker should be, only with prior regulatory approval. Such minimum additional capital should be not less than 40 % of the above paid-up capital**

limits suggested for the Metro, the State Capital and other places, for each office so opened, depending on the location of the new office. 10% of such additional capital should be kept in Fixed Deposits.

- **Not less than 25% of the annual post-tax surplus generated should be transferred to the reserves. 50% of such reserves should be held in approved liquid assets.**

- **Financial viability of a broking firm can be gleaned mainly from examining the annual financial statements that should be based on accounting standards to be prescribed in consultation with ICAI. Onus should be on the statutory auditors 'to blow the whistle,' if any irregularities are suspected or detected. As the broker is a legal representative of the consumer, more care is necessary to ensure their financial and professional discipline.**

- **The Authorized capital of the broking company stated in its Memorandum & Articles of Association should be adequate to take care of the additional capital needs of the broking firm, as and when it expands its network.**

<u>**Term of reference 4 (c):**</u>

4(c) Issues relating to the brokers acting as risk managers/risk management consultants /claims advisors, etc.

The '**functions'** of a broker are prescribed under the Brokers' Regulations 3, 4 and 5, for each category of broker licensed.

The functions include: "*providing services related to insurance consultancy and risk management' and "assisting in the negotiation of claims*". These are functions to be necessarily performed by a broker, as part of his duties to his client. The amount of remuneration payable to him, and by whom, for performing these functions, duties and professional services is altogether a different aspect. This has been dealt with separately in Regulation 19.

Regulation 19, A, B and C sub-section 1 stipulates the 'remuneration' payable to a broker. It stipulates: "No insurance broker shall be paid or contracted to be paid by way of remuneration an amount exceeding (various percentages prescribed) of the premium". The Section 2 of the same Regulation 19 says, "The settlement of accounts by insurers in respect of remuneration of brokers shall be done on a monthly basis…"

It is obvious from the two quoted stipulations, 19 (1) and (2), that they are only applicable to insurers and their conduct towards the maximum "remuneration" they should pay the

broker for the business placed by him. It should not be confused nor should it be interlinked with payments, if any, received by the broker from an insured for his specialized professional services rendered for that particular client, as a part of their mutual agreement.

While detailed broker functions are described to define the role and the duties of a broker, the regulations on remuneration applies only to what should transpire between the broker and the insurer. To give these provisions any meaning greater than the one intended above-- that a broker should not claim from or charge additional fees to an insured, who is willing enough to pay a broker to avail himself of such services—is not appropriate and not tenable. In addition, it would cause serious financial injury to the broking profession. It is also not in keeping with the provisions of the code of conduct, as discussed subsequently.

In the case of another regulated intermediary, the surveyor, his duties under surveyors' regulation 13 (2) (ix) permit him to survey and assess loss on behalf of the insurer **or insured**. Intermediaries are primarily professionals in their chosen field and offer their services to those that need them and pay for them.

Similarly a broker, when he acts for the insured, has a legal responsibility to the latter, as his agent. But at any other time, when someone else, who is not his insured, asks him for specific advices on an insurance related subject, he should be free to offer his professional services; as a consultant does, with a different legal responsibility between the two. The legal relationship between the two roles one of broker and the other of consultant is different.

There is a restriction under code of conduct provisions applicable to brokers, under 7 (e) thereof, that 'the broker shall not take up a recovery assignment on a policy contract which has not been serviced through him or should not work as a claims consultant for a policy which has not been serviced through him". Such an omnibus restriction on the broker, it is felt, is rather harsh. The broking activities have been licensed only recently.

As such there may be many insured, who may seek professional services to follow their unsettled claims, and who may not have used the services of the brokers in the past. Equally, it would be unethical, if a broker were to use this opportunity to divert business from another broker that is servicing the policy.

It is not clear why when a surveyor is permitted to offer consultancy services to a client, he does not service, a broker should be prohibited from doing so. Should any "conflict of interest situation" should arise or there is a possibility of "unethical conduct' situation, it should be dealt with separately.

It should be open to an insured to decide on the claims consultancy issue. The only regulatory restriction should be that no broker should offer such claims recovery services, where another broker is already servicing the account. Should an insured insist that he would like to replace his current broker's services with another, for whatever reason-- including the unsatisfactory services of the former-- a new broker could take up the assignment, after getting the written consent from the servicing broker?

The insured must have a choice of replacing his broker, without which, his broker, in the event of a dispute with the customer, could conduct his business to the detriment of the insured. The present code of conduct restriction 7 (e) should, therefore, be deleted or modified suitably in the interests of the client himself.

Brokerage collected from an insurer has to be considered as distinct and separate from other professional fees collected from an insured, for any specialized services rendered or to be rendered, as the broker and the insured may mutually agree, in advance of concluding the insurance transaction. A broker is legally an Agent of the insured, his Principal, and it is for both of them to conclude a voluntary arrangement between the two, in which they both are happy, without the regulatory oversight, so long as there is a full financial disclosure.

The world over, brokers are offering various professional insurance and other specialized services and are remunerated only by those who utilize such professional services for specified purposes that are agreed to, in advance, and paid on delivery of such services. The "remuneration" paid to brokers by insurers should not prevent brokers from negotiating separate professional fees from the prospective insured. It is, in fact, only necessary, under the code of conduct provisions, to inform the prospective insured of the broker's functions and the remuneration scale he would receive from the insurer and what additional costs he would additionally charge the insured, before he commences broking on behalf of the insured.

The "Code of Conduct' provision 11 enjoins the broker on his conduct towards matters relating to receipt of remuneration, and makes this point even more explicit. It states, "Every insurance broker shall:

(a) Disclose whether in addition to the remuneration prescribed under these regulations, he proposes to charge the client, and if so, in what manner;
(b) Advise the client in writing of the insurance premium and any fees or charges separately and the purpose of related services;
(c) If requested by a client, disclose the amount of remuneration or other remuneration it receives as a result of effecting insurance for that client. This will include any payment received as a result of securing on behalf of the

client any service additional to the arrangement of the contract of insurance; and

(d) Advise the client, prior to effecting the insurance, of their intention to make any deductions from the amount of claim collected for a client, where this is a recognized practice for the type of insurance contract."

1. Following the above analysis, the Committee recommends that the brokers should be allowed to act as "Insurance Consultants and Advisers including Claims Advisers", which the present regulations already permit, subject to their collecting all such professional fees from the insured for services rendered to him; and none at all from insurers except the prescribed and specified brokerage called "Remuneration". The brokers can also be permitted to do consultancy work for their clients, whose business they place and other potential insured as well.

2. The PI policy taken, however, should take care of the new duties they would perform as "Consultants" and "Claims Advisers" in the cover.

3. The brokerage or remuneration received from the insurer/reinsurer should mandatorily be disclosed to a client irrespective of whether he sought the information or not. It may be stated that the FSA in UK is actively examining the issue and veering round to the view that brokerage and other fees paid by insurers should be invariably disclosed to the insured, as a rule, to prevent unhealthy financial practices to creep in now or later. The Indian model of disclosure of brokerage would make the level-playing field on remuneration more transparent.

4. Insurers and brokers should be prohibited, preferably, by a regulation to be enacted, from entering into a Managing General Agency System, under which the brokers claim additional remuneration from the insurers, as administrative costs towards issuing policies and for other services. It is understood that such practices in the absence of specific prohibition are current here and there.

<u>**Term of reference 4 (d):**</u>

4 (d) The levels of brokerage that can be considered fair in a non-tariff market place from the points of view of the buyers of insurance, the brokers and insurers:

As far as the remuneration payable to a broker, in a non-tariff environment is concerned, the Committee has examined the role, the functions and the duties of brokers and the sources of income available for their expertise. They must have incentives—technical, professional and financial—for their specialist services on offer to the market. The brokerage income should be a major part of their total revenue cake; and not its entirety.

As such, their brokerage remuneration would have to be dealt with in a manner, different than at present and not as their sole and only income stream.

The withdrawal of the special discount of 5 % now given on fire and engineering covers to those corporations above the Rs 15 crore paid-up capital--which would include all the public sector corporations (following detariffing) provides the brokers a greater potential to develop their brokerage income from them. On all counts: of risk management, consultancy services and a bigger marketing field to operate in, the brokers can expect their expertise to fetch them larger incomes.

Based on this understanding, and keeping in view the insurers' current high costs of selling their insurance covers that are unacceptably high-- making the covers almost unaffordable to many consumers-- and recognizing that in a non-tariff market, the premium rates are likely to drop or even plunge, and to ensure that the international reinsurance facility, including cat facility, continues to be available to domestic insurers at economic prices, sacrifices would have to be made by all stakeholders, including the intermediaries.

The Committee is concerned with the impact of high levels of brokerage remuneration on the insured society as well and its effects on the insurance stakeholders. Arguments have been put forth that high brokerage remuneration would continue to encourage and make the evil of 'rebating' raise its ugly head. The insured would demand that he be given his share of the "kickbacks". On the other hand, a low remuneration would prove uneconomical to the broker to carry on his operations. Striking a balance between the two is rather difficult. But a balance has to be struck.

In the de-tariffed scenario, it is expected, that the fire and engineering premiums may drop by about 20 percent from the current levels. Consequent on such fall in rates, the insurers themselves would get lowered reinsurance commissions from which they have to meet the brokerage payment. In addition, the insurers Non-proportional treaties would have lower net premiums that would jack up reinsurance rates. Insurers, squeezed by lower reinsurance commissions and higher payouts for non-proportional covers, would be hard put to pay higher percentage of brokerage.

Taking in to consideration that the insurance brokers, have been given a wider field to display their professional expertise in risk management, consultancy and claims advise to all consumers, and with the brokers continuing to have a choice provided in the code of conduct to collect fees from the client, if such fees is notified in advance, and as de-tariffing would enable them to canvass business from all public sector corporations hitherto available to them on a restricted basis, the Committee recommends that the brokerage payable should not exceed 12.5%, as maximum

remuneration (brokerage) for all non-statutory covers in the non-tariff environment. For statutory covers it should be restricted to a maximum of 10 %, as is current.

In the interests of transparency of disclosures the broker must compulsorily disclose to the client the brokerage paid by an insurer on the policy. At present the code of conduct provision 11 (c) states that:" if requested by a client, every insurance broker shall disclose the amount of remuneration or other remuneration it receives as a result of effecting the insurance for that client". Quite often, the client being unaware of the existence of this choice may not seek the information, though he may want to have it.

It is reported that the FSA (Financial Services Authority), in the UK is not quite satisfied with the present arrangement in force in the UK system, on the disclosure of broker remuneration to the client, similar to the one in India, as described above. The FSA is considering mandatory disclosure of brokerage to the client, as after all, the brokerage payment is actually made by him, though routed through the insurer. The client has a right to know what it has cost him in intermediary services. In the UK, brokers deduct their brokerage (unspecified) and then reimburse the risk premium to the insurers.

The Committee recommends that such a good business practice, of financial disclosure, particularly one that impacts on the broker's remuneration on the duties rendered to the client, must be implemented; as broking itself is new to the market and to the client.

It is recommended that IRDA may prescribe compulsory disclosure of remuneration, received in any form, from the insurer to the client, for placing his insurance contract. Whether the brokerage paid should be shown in the policy itself may be examined. This would call for a suitable amendment to the code of conduct provision 11 (c).

As far as the Agents and Corporate Agents are concerned, the Committee feels that this under-developed and un-exploited agency system needs continued encouragement and perhaps more investment from insurers by way of training and other facilities. They are the future anchor sheets for developing personal lines and rural insurance covers that is not generally targeted by any other distribution channel. They are also constrained, having tied their apron strings to one insurer. One cannot suffocate their business survival instincts any further by lowering their remuneration substantially.

The justification to maintain a differential in the remuneration levels between a qualified broker and a qualified agent cannot be easily brushed aside. That an agent needs greater stimulus in training and nurturing and grooming is also admitted. Insurers must exert themselves more to building up this force. Having to make a reluctant choice in the

remuneration levels between the two important distribution channels, the Committee has come to the conclusion that a differential in the remuneration structure of 2.5% between the two be continued, as before.

The Committee has also considered if separate agency/brokerage remuneration levels are desirable portfolio-wise. But since the market is converting itself into a non-tariff one, and as availability of products to the consumer must be at affordable rates, it would be necessary to contain the costs of distribution. For simplicity of administration, and due to lack of data of how each distribution channel has performed in each portfolio, the Committee finds itself that it is unable to make a reasoned evaluation of such a proposal.

The ideal situation would be for insurers to reduce their present massive costs of management; but in the immediate future it seems very unlikely. The General Insurance Council has a statutory responsibility to take measures to reduce the costs of management and it should apply its mind seriously to this aspect, and as quickly as possible.

The Council must be directed by the IRDA to do so; as apparently no attention at all till now has been directed towards reducing the insurers' own costs of management, whereas a significant attention has been paid on the costs of distribution incurred. This cost paradox has to be addressed. Keeping both these costs at the possible lowest levels is beneficial to the consumers and would ultimately lead to penetration levels of insurance rising faster. Making available insurance covers is also a matter of their affordability, particularly as the total costs of availability is as high as over 35 percent of the earned premiums.

Currently, the IRDA is prescribing the distribution costs, as under the Insurance Act 1938 there are maximum ceilings on remuneration payable prescribed for each channel. This has been the case, as the Act has assumed that the tariff market would continue to be based on a tariff structure of rates. In the scenario, wherein the market is likely to be freed, it is argued that the market forces should determine the intermediation costs; just as the market forces do for the rating structures. There is merit in this submission.

The IRDA may, in the event of detariffing rating structures, consider ensuring the deletion of the provisions on ceilings on the remuneration levels of distribution channels. As also if the IRDA should continue to license Agents of insurers, as it should be a matter between the Insurers and the Agents. The IRDA should only control their market conduct and not licensing the agency force.

The Committee, therefore, recommends that the remuneration levels for the agency/ corporate agency structure be retained at 10% for the non-statutory covers. For statutory covers the agents/corporate agents should get the same 10 % as brokers.

This is one distribution channel that provides self-employment opportunities to thousands of persons. If they have not done as well as expected, it may be due to the apathy of their Insurers that is the cause and not their inability to function.

It is also recommended by the Committee that the brokerage remuneration and agency commission levels be reviewed, once insurers cut their costs of management (excluding the distribution costs) to the satisfaction of IRDA or once the market prices, after detariffing, show reasonable signs of stability. It is estimated that this may take three years.

A review of remuneration structure at the end of the three-year period may be undertaken. Also there is a need to consider, even at this stage, whether the maximum remuneration levels should continue to be as stated in the Insurance Act or left entirely to the market forces.

Term of reference 4 (e):

4 (e) Examine the desirability of continuance of the system of Composite Brokers vis-à-vis their operation

Neither the Insurance Act 1938 nor the IRDA Act 1999 recognizes a Composite Broker as 'an intermediary or insurance intermediary'. An insurance intermediary, according to the IRDA act 1999 "includes insurance brokers, reinsurance brokers, insurance consultants, surveyors and loss assessors". It is only the Broker regulations that have given the Composite Broker a legal identity. Whether this is adequate from a legalistic point of view of their role is to be examined by the IRDA. There are 25 licensed Composite Brokers whereas there are only 4 licensed Reinsurance Brokers. Notwithstanding the important issue of the legality, the desirability of continuing with this category of "Composite Brokers" has been examined below. It is one of the Terms of reference given to the Committee.

The activities of the Composite Broker, whose duties include representing the interests of the primary insured, as his agent vis-à-vis the insurer, as a direct broker is permitted to switch his role as the agent of the same insurer, as a reinsurance broker, while placing the business for reinsurance.

This situation does result in an anomalous legal situation. In a single transaction he vouches for his impartiality and professional competence; once to the insured and again in the same transaction to the insurer, with whom he later deals with for his reinsurance. He is also entitled to collect brokerage from both the insurer and the reinsurer, for his professional activities, for one transaction. In the event of a single event going sour, to whom is he legally accountable? The insured or the insurer? It is not clear how his PI policy for errors and negligence is currently protecting his twin roles. At the best of times,

the integrity of a composite broker is always suspected in the eyes of the insured, whose business creates the twin transactions.

The Committee has received quite a few submissions, including from insurers that the conflict of interest is inherent in the functions and activities prescribed for the Composite Broker. It has also manifested, in a few cases, according to one insurer. Further, the Composite broker can obtain reinsurance terms in advance and ask an insurer for cover on terms so negotiated by him, forcing him to accept the dictates of the Composite broker, and indirectly asking him to front for the reinsurer, for a management fee than as a risk – carrier.

The present norm of licensing Composite brokers is potentially harmful to the future ethical standards of the insurance market and these can be subverted more easily in a non-tariff market. All the public sector corporations that would become eligible for non-tariff rates, following the withdrawal of 5 % special discount, would become vulnerable to possible enticements, based on reinsurance dictated terms and the Composite broker attempting to get two separate brokerage payments for a seemingly single contract.

With MNC contractors entering the market for work related contracts, the tendency of having their global policies fit in the insurance contracts in India to reduce their overall premium costs, would lead to their Composite broker abroad finding a Composite broker in India to locate a fronting Indian insurer. Such practices, already inherent, must be discouraged at the entry level. Doing away with the licensing of composite brokers is a necessary step.

The Committee is of the considered view that further licensing of Composite Brokers be stopped. Those that have been issued licenses may be asked to apply separately for licenses for direct and reinsurance broking at renewal. There would be two legal entities with separate responsibilities and accountability norms. Currently, there are only 4 RI brokers, where as there are nearly 25 Composite Brokers.

Accounting–wise too it would be helpful to judge how the domestic broking and reinsurance broking activities are shaping up separately to make independent assessments of the performance of the direct and reinsurance brokers.

<u>Term of reference 4 (f):</u>

4 (f) Steps to be taken for effective supervision of the brokers by IRDA;

A number of corporate governance recommendations made above by the Committee, if implemented, would provide a broad framework for IRDA to ensure the improved functioning of the broking firms. The internal audit control system, which the broker is

called upon to implement, has to be independently checked for its compliance. The specific accounting standards, including the disclosures and transparency standards, need to be prescribed by the ICAI; and certification thereof must be done by the statutory auditors, as also of the implementation of regulations and the code of conduct provisions.

It is understood that no inspection of broker accounts has been done, except in cases where complaints were received from the public. On-site inspections should be carried out by the IRDA staff or preferably outsourced to get faster compliance. Pro-active monitoring of the affairs of insurers and brokers would assist IRDA in setting proper propriety standards in a non-tariff market. It is pragmatic to be vigilant in regulatory supervision at the beginning than try to weed out the unacceptable and unlawful practices detected later on.

With the compulsion on the broking community to become a member of the IBAI, when a broking license is granted, greater thrust has been shifted to the IBAI to perform its duties, as a SRO. Efforts should be made to have the IBAI revamped and independently structured, like the Surveyors Institute. IRDA could ensure elections to the IBAI, whom it has recognized, on the lines of the Surveyors, in its efforts to promote a professional body.

Term of reference 4 (g):

4(g) Review the current reporting forms for brokers and suggest improvements therein:

Form B relating to Directors should have the qualifications, experience, and the date when the broker's examination was passed by each Director. This is in line with the recommendation of the EC to have a majority of directors as professional brokers interested in developing it as a world-class broking firm.

Form D needs to provide additional information on the frequency of internal audit done, the relevant period covered, any major irregularities or breaches of regulations and code of conduct detected during the period. It should also be ensured that these reports should be made available to statutory auditors for their comments in the annual financial statements.

Form E should also cover the name of the branch at which each soliciting broker (to confirm he is a salaried employee) is working and should contain information on the date when such a person has passed the broker's examination. Such a person should be an employee of the broking firm and not a 'franchise'.

Form F should cover the costs of management of running the branch and the brokerage and other revenues derived separately by the branch.

Form H should ask for brokerage received for each department and from each insurer separately. The same should apply for a RI broker; but the miscellaneous segment needs to be rearranged into aviation, energy, mega risks etc.

Form I can be eliminated as the EC has recommended that the statutory auditor should certify it every year.

Form K can be dispensed with. The insurer in his PI document, and the broker as the insured, should be asked to individually certify that the PI policy is in accordance with regulatory requirements.

<u>Term of reference 4 (h):</u>
4 (h) Any other matters considered appropriate in the above context:

1. Service Tax:

- One of the issues the Committee recommends IRDA to examine is the reimbursement of service tax to brokers. In the case of brokers, there are differing market practices by insurers; a few of them reimburse brokers of the service taxes on brokerage paid and a few do not. Since the maximum brokerage is prescribed, the IRDA comes into the picture to deal with this issue. Would payment of service tax amount to additional remuneration that a broker is not entitled to?

  Technically and legally, the broker is rendering professional services to and on behalf of the insured; he is also empowered by the IRDA code of conduct provisions to collect any additional fees from the insured after due notification. This should include service taxes as well.

  Since the broker does not perform or render any professional service to an insurer, should an insurer pay service tax to a broker boosting the insurer's distribution costs? As the brokerage income is likely to go up substantially in a non-tariff market with rising premium volumes annually, this issue needs a ruling. In the view of the Committee, the payment of such service taxes to brokers is not in keeping with the current legal and regulatory provisions.

  Hence, the legality of reimbursing brokers with the service tax on brokerage paid by insurers, who do not receive professional services, needs examination. Would reimbursement of service tax to a broker constitute a violation of any known laws? Only a legal opinion can render a proper guidance on this issue.

2. **PI Policy:**

- The PI cover issued by insurers, in some cases is not in keeping with the regulations; former employees are not covered under a few policies; in some cases civil liabilities for dishonest and criminal acts are covered and then later excluded under the exclusions. There is a need for IRDA to have a mechanism in place to ensure that defective policies in violation of the regulations are not issued.

  IRDA may ask the broker to confirm that the PI policy issued is in accordance with the regulations; further IRDA should ask insurers to incorporate the content of regulation as a part of the policy document.

3. **20% Paid-up capital in bank:**

- Regulation 22 stipulates that the broker should confirm that 20 % of the capital is tied up in a FD." Every insurance broker shall furnish information relating to this FDR to the Authority as and when called upon to do so.

  It is preferable to have such certification for the 20% amount kept in a bank done by the statutory auditor, at the time of his signing the financial statements every year. This would ensure continuity and not put the onus on the IRDA to take the initiative.

4. **Main Objects in Memorandum:**

- Regulation 9 section 2 (H) states that 'the applicant is not engaged in any other business other than the main objects of the applicant'. By implication it is meant "broking activity". In one case the main objects stated included sub-broking, agency, surveying, franchising etc.

  It is recommended that the main objects should be restricted to Broking and other allied consultancy services. This would also obviate a broker to work for an insurer in any capacity, including as an agent by issuing policies etc on the insurers' behalf and collecting additional remuneration from Insurers that is now prohibited. A specific provision in the code of conduct should be made to make the position unambiguous that except broking and other allied consultancy services, no other activity should find a place in the Memorandum of Association. Brokers may be asked to amend their "Main Objects" suitably.

5. **Raising Foreign Equity:**

- **The foreign equity is now restricted to 26% as per Regulation 10 (2). Since there is no statutory bar (there is only a regulatory bar on this) for limiting the foreign equity in a broking establishment to 26%, (it applies only to insurers)**

the Committee is of the view that this limit may be raised to 49 %. The purpose should be to gain professional knowledge, expertise and have access to international markets in respect of complex risks and of higher value.

6. **Filing Annual Statements:**

- It is understood that brokers have asked time to file annual statements till the end of September. The Committee feels that this request is not fully justified based on the number of transactions a broker engages in. When major insurers are finalizing their annual statements within three months of the close of the financial year, there is no reason why any broker should find it difficult to finalize them within current time limits.

  No relaxation of regulatory norms should be permitted in the interests of maintaining discipline in filing of Annual returns, nor does the regulation permit consideration of any relaxation of the time limit except by an amendment to the regulation already made.

7. **Remuneration from Insurers (additional to brokerage)**

- Section 40 of the Insurance Act 1938 states that no remuneration or reward or commission is payable **in any form** except to an Agent / a Broker, for soliciting or procuring insurance business. No other remuneration, other than that specifically prescribed under the Regulations, shall be paid **in any form**, any amount in respect of any policy not effected through him. . Brokers, in the provisions, are not entitled to receive any "fee" from insurers other than the prescribed brokerage. This is a direction to the insurers, who are the beneficiaries of business. The word "fee' is added only in case of brokerage in the Insurance Act 1938, section 42 E.

  If any additional "fee' or any other remuneration is paid to the broker by an insurer or any other service is rendered to the insurers on the insurance policy placed with him, it amounts to breach of the section 42 (E). It was instanced before the EC that a few insurers are reimbursing "fee" for risk inspection reports furnished by brokers or allowing brokers to issue policies on their behalf, at a fee paid to them. Such a practice, in view of the specific legal provision in 42 (E), would contravene it. It may also amount to rebating. The IRDA may examine the issue and take a decision on the matter.

8. **Brokers' responsibility to insured on choice of insurer:**

- A broker has a basic responsibility to advise an insured on the choice of an insurer for placement of his insurance business. For this purpose, not only is the premium rate quoted by an insurer an important influencing factor but also the ability and the

reputation of such an insurer to pay claims is seen as even a more important factor to make the final choice. In a detariffed market, the balance sheets of the insurers are expected to go haywire; a few of the insurers may resort to substantial reinsurance for support of lower quotations. The broker, therefore, needs to have financial information of the insurers, at regular intervals, to make his recommendations to the insured, on the choice of the insurer.

The broker has currently no access to this financial information, in the absence of non-publication of quarterly un-audited financial statements by insurers. (Even annual statements are not published). He has also no authority to ask and satisfy himself, on behalf of the insured, that effective reinsurance placement with BBB rated reinsurers has been done and the extent thereof.

It is, therefore, highly desirable, particularly in a non-tariff market for the IRDA to keep a vigilant eye, at frequent intervals, on the financial performance and status of the insurers. While it may not be mandatory to file quarterly un-audited statements, it may assist the IRDA, the brokers and perhaps the insurers themselves to keep a tab on the financial information. The new players may have no problem to comply with such a provision; the established players too are now geared in their IT systems to produce quarterly un-audited statements.

The market is an open and free one. But no financial information is made available to the consumers, at regular intervals to make their choice of the insurer with whom they or their brokers wish to deal.

This current information gap, to the prejudice and detriment of the insured and his broker, needs to be restored either formally or informally. There should be a definite movement for fuller financial disclosure and more transparency and at quarterly intervals: or else the burden of monitoring the financial status of insurers on the IRDA would be greater. Can this responsibility of disclosure be passed on to the insurers? And by what mechanism?

Publication, or at least submission of quarterly un-audited statements to the IRDA, by each insurer may be insisted upon. Insurers should even be encouraged to publish them as a tool of ‘best business practice’. The insured must be provided information, when asked, of the extent of reinsurance placed on his risk; and if it has been done with reinsurers ranking above BBB as per regulations.

In a total non-tariff environment, wherein the rates could go down to uneconomic levels, the un-audited underwriting results and the comparative

profitability of each insurer needs to be measured at frequent intervals. The Authority has no other financial mechanism to assess the direction in which competition among the insurers is taking the industry and for any course-corrective actions to be initiated. This single step would improve corporate governance of insurers.

The insuring public and the brokers have a right to know, as a matter of reciprocal obligation of utmost good faith on the part of the insurers, to be informed of the relative financial status and strength of each insurer. Since all insurers are issued licenses by the IRDA, the public should not be mistakenly led to believe that all insurers stand on the same financial footing. Suitable measures on this matter may be considered by the IRDA.

9. IRDA's Circular of 15th September 2006:

- The Committee was informed of a circular issued by the IRDA on 15th September 2006 titled " Guidelines on insurance and reinsurance of General Insurance risks" to the Insurers and all broking companies. These guidelines are also termed therein as "rules of conduct' for insurers and brokers, particularly in respect of risk with high sums insured.

The Committee, while framing its recommendations, particularly on the desirability of continuance of Composite Brokers, has considered this circular and its views that continuation of licensing of Composite Brokers is not desirable, remains, as stated herein. There is a definite conflict of interest situation in the insured/broker/insurer/reinsurer transaction to the detriment of the development of the market and the interests of the insured himself.

When, or at what point of time, such a conflict of interest would manifest, is a matter of time. With more and more MNC contractors entering the Indian market, with their worldwide insurance policies, there is a definite incentive for a Composite Broker to find an insurer, who would pay him brokerage for the reinsurance already in place and also collect brokerage from the Indian insured, who no longer is entitled to the special 5% discount and as such may pay brokerage for broker services.

As the developed markets are discovering—arising out of the scandals of collection of contingency fees in US market by the brokers, that resulted in bid rigging—despite regulations in force against bid-rigging, it took years to discover such wrong practices and the issuance of threats of criminal action to cleanse the system of such practices that border on thin legalities.

Irregularities in Composite broking and in general broker misuse of business practices take much longer to detect than those of insurers, as the audit and accounting systems and regulatory control on insurers are more stringent than on the brokers.

SUMMARY OF RECOMMENDATIONS:

1. A register of all licensed broking entities, individuals and bodies corporate, must be maintained by IBAI / IRDA giving, as many particulars as possible, including category of its insurance activities such as direct, reinsurance or any other, the profiles of the directors, the individual brokers working for each, the number of offices of each entity, its license number, its date of expiry for the interested public to have more information about brokers to access, particularly in a non-tariff scenario. Such information should be available on the website for the public to access.

2. A separate register, of all qualified insurance brokers that have passed the IRDA prescribed insurance broking examination, showing their names, addresses, qualifications and experience, should be maintained separately. This register would also serve as a collection of a "talent pool' to recruit insurance brokers for future needs of the market.

3. All bodies corporate and partnership firms, seeking broking licenses in future, should have, at least one of its directors in the case of the former, and at least one partner in the case of the latter, passed the IRDA prescribed insurance brokers examination. In addition the Principal Officer should be co-opted as a director on the body corporate. Where the body corporate has not co-opted the Principal Officer there should be at least two directors qualified as licensed brokers. Further licensing of brokers may be done only after this provision is fulfilled. In respect of those broking entities that have been already licensed, a time frame of one or two years may be given to have this requirement fulfilled.

4. Mandatory training of 100 hours may be dispensed with. IRDA's prescribed insurance brokers examination that is now conducted by the Insurance Institute of India and other bodies must be more stringent than now. It should be based on the lines of syllabus designed for Chartered Brokers Examinations of the UK and must also test the candidates in current regulations in force for all distribution channels. The holding of examinations must be advertised to enable all available and willing professionals to sit for the said examination, at their cost, and qualify themselves as" Registered insurance brokers" eligible for future employment with brokers or engage themselves as brokers in their own right.

5. Common directors on IRDA's regulated bodies should decide to sit only on one regulated body to avoid any conflict of interest to creep in from one activity to another.

6. No broker should open an office, by whatever name called, without prior regulatory approval. In addition, such opening of an office should attract injection of additional capital and should have additional qualified insurance broking manpower, as prescribed. Existing brokers who have already opened offices should immediately report to the IRDA the various office locations and the manpower availability at each. The injection of additional capital required to be met progressively, within a time frame to be specified by the IRDA. The Committee is of the view that two years should be the maximum period to be allowed.

7. The minimum paid-up capital norms for new brokerage applicants should be based on the location of the head office of the brokerage house. It varies between a minimum of Rs 30 lakhs to Rs 50 lakhs to encourage the spread of independent broking entities and to facilitate current entities to open new branches.

8. Sub-broking issue was considered and is not recommended. Those broking entities that are currently indulging in sub-broking or franchising entities, should be warned in writing and asked to discontinue such arrangements forthwith. The opening up of the market from price controls makes this action immediate.

9. The Accounting information and data furnished by brokers needs a review. It is recommended that IRDA, on its own or in consultation with the ICAI, may prescribe a new set of accounting standards of financial disclosure. IRDA may prescribe a "management report' format to review the IRDA prescribed activities of the broking entity. The statutory auditors should be asked to certify the efficacy and quality of internal audit systems in practice and whether the entity is complying with the broking regulations and code of conduct. In effect, in the absence of periodic inspections by the IRDA, it should have other sources to report on the performance and activities of the entity. None can serve this purpose better than the statutory auditors.

10. Brokers should be permitted to undertake claims consultancy services to any client, with safeguards built in to take care of ethical and legal formalities. Brokers, in respect of clients serviced through other brokers, must get written approval of the said client and a no objection letter from the servicing broker. Such cases should be compulsorily reported to IBAI routinely. The current prohibitory proviso may be reworded to enable brokers to professionalize their claims services and earn incomes, based on their competitive merits and professional capabilities. Such practices abroad in developed markets are common but based on built in safeguards of ethical conduct.

11. The brokerage income payable by insurers on the contracts of insurance placed with them is just but one source of brokerage income. The code of conduct permits the broking entities to claim additional fees and charges from their clients for particular services rendered to them, if these are made known in advance of placement of insurance and agreed to between the client and the broker.

    If claims consultancy services are permitted, as the Committee recommends, to be taken up by broker for other clients, whose business is not necessarily serviced by them, it would open up another income stream. In view of various income channels available for broking entities, the brokerage income should only be a part of their total income, though it should be a major part.

    The brokerage paid must be compulsorily disclosed to the client, and not only when a broker is asked for making this information available. The FSA in the UK is considering making this stipulation compulsory.

    Considering that rates in a non-tariff environment are likely to go down than up, the Committee recommends that a maximum of 12.5 percent brokerage for all non-statutory covers is adequate and reasonable. For statutory covers it should remain at current levels of 10 %. For Agents and corporate agents of insurers, the commission payable should be 10 percent, for both the non-statutory and statutory covers.

12. Composite brokers are not defined separately in the IRDA Act 1999, and neither are they specifically mentioned under the definition of: intermediary. This limitation raises the question if the Statute intended to have Composite brokers at all in the list of intermediaries. Irrespective of this limitation, the Committee feels strongly that the potential for a conflict of interest situation arising is too great. Many participants who met the Committee reaffirmed this view. The previous committee headed by Shri A C Mukherki was also of the same view.

    The Committee, therefore, recommends that future licensing of Composite Brokers be discontinued. Those that have been given licenses for Composite broking by IRDA should be advised that before their next renewals, they should split their broking activities in to two viz. direct broking and reinsurance broking, as two separate legal entities.

13. The reimbursement of service taxes to brokers by insurers is another issue. There are differing practices indulged in by insurers. As brokers are rendering services to their clients, and not to insurers that accept business on behalf of the insured, reimbursing service taxes to the broker is as good as returning a part of the service

tax paid by the insured back to the insured. This needs legal guidance and IRDA may look into it.

14. The Memorandum and Articles of Association (M & A) of broking entities contains several incidental functions, contrary to what the broker regulations intended or permitted. Permitting filing of such a document may cause avoidable problems in times of conflict between the broker and the IRDA. Brokers should not feel that having filed it and then got a license, they can act according to what the M & A says and such activities are within the knowledge of the IRDA, even if not approved by them. The committee recommends that the M & A should have only one object and no other subsidiary objects should be permitted.

15. Foreign equity is fixed at 26 percent as per current regulations. There is no statutory bar for a foreign firm to have a higher equity participation in the broking entity. The committee recommends that the foreign equity may be raised to 49 percent as a first step.

16. In a non-tariff market the rates are expected to go downward rather than upward, placing the financial resources of insurers under strain. The principle of utmost good faith applies as much to insurers as to the insured. The Committee views that though insurers are licensed by the IRDA, it is imperative that the public, including the insured and the brokers, should be reassured of the financial viability of insurers themselves. The IRDA needs to have a mechanism to keep the financial status of insurers under regular review and watch, in a price freed market..

    The Committee recommends that all the insurers must, without exception, file comparative un-audited quarterly underwriting results and their profitability including investment income separately, with the IRDA to ensure their continued viability. This would enable IRDA to monitor, from time to time, how the detariffing of rates is affecting the market. The insuring public needs to be reassured on this front.

17. Other recommendations not specified above have been made under the relevant terms of reference. Hence the summary of recommendations made herein should not be considered as exhaustive and complete.

G K Raman	**G.V.Rao**	**B.Chakrabarti**	**M.Ramadoss**	**S.V.Samant**
Chairman	**Member**	**Member**	**Member**	**Member**

Place : Hyderabad　　　　Date : 14th November 2006

Annexure 1

Notification & Terms of Reference

19th July 2006

ADM/ORD/76/June-06

Re :Expert Committee on Brokers and Broker Related Issues

The broking companies which currently number over 200 have been operating in the market. The brokers have been functioning for 3 years now and the Authority has considered it desirable to constitute an Expert Committee to review the Regulations governing the licensing of brokers in the light of the experience of IRDA in the past three years and for making such recommendations as considered necessary to strengthen the role of brokers more particularly in the context of the de-tariffing of non-life insurance being proposed by the Authority. Accordingly, a Committee is constituted with Shri G.K.Raman, Chairman, Royal Sundaram Alliance Insurance Company Ltd., as the Chairman of the Committee with members drawn from the industry. The composition of the Committee is furnished below :-

1. Shri G.K.Raman - Chairman
   Chairman Royal Sundaram Alliance Insurance Company Ltd.

2. Shri G.V.Rao - Member
   Former Chairman & Managing Director Oriental Insurance Company Ltd

3. Shri.B.Chakrabarti - Member
   Chairman & Managing Director - New India Assurance Company Ltd

4. Shri Shrirang V.Samant - Member
   Managing Director - HDFC Chubb General Insurance Company Ltd

5. Shri M.Ramadoss - Member
   Chairman & Managing Director - Oriental Insurance Company Ltd

Shri M.M.Siddiqui, Consultant & Special Officer, IRDA would function as the Convenor of the Committee.

The Terms of Reference of the Committee are annexed.

The Committee is required to submit its report for consideration of the Authority within two months from the date of its constitution.

-sd/-
(C.S.Rao)
Chairman

Terms of Reference

To review and make recommendations on the following issues:-

1. Review the developments in the broking profession since introduction of Brokers Regulations 2002.

2. Review the business practices in broking with particular reference the adequacy of the existing number of brokers for promoting healthy competition:

3. Review the level of professionalism in the business and recommend further measures to enhance and promote the same.

4. Review the adequacy of the Brokers Regulations and Code of conduct for the Brokers and make recommendations for improvement thereof with particular reference to:

   (a) Corporate Governance of brokers and prevention of conflict of interest;

   (b) Financial viability of broking companies, adequacy of existing capital requirement and other prudential controls considered necessary to ensure continuing financial soundness of operations;

   (c) Issues relating to the brokers acting as risk managers/risk management consultants /insurance consultants/claims advisers, etc.

   (d) The levels of brokerage that can be considered fair in a non-tariff market place from the points of view of the buyers of insurance, the brokers and insurers;

   (e) Examine the desirability of continuance of the system of Composite Brokers vis-à-vis their operation;

   (f) Steps to be taken for effective supervision of the brokers by IRDA;

   (g) Review the current reporting forms for brokers and suggest improvements therein:

   (h) Any other matters considered appropriate in the above context:

Annexure 2

List of names of Organisations met:

S.No.	Name of Companies/Brokers/Chambers of Commerce
1	Bombay Chamber of Commerce & Industry
2	Reliance Mutual Fund
3	Indian Merchants' Chamber
4	Indian Institute of Insurance & Risk Management
5	National Insurance Company Limited
6	TATA AIG General Insurance Company Limited
7	National Insurance Academy, Pune
8	First Insurance World Broking Services
9	Royal Sundaram Alliance Insurance Company Limited
10	Insurance Brokers Association of India
11	Heritage Insurance Brokers P Limited
12	DIC India Limited
13	Nipun Insurance Brokers P Limited
14	Bengal Chamber of Commerce & Industry
15	Willis BA India Private Limited
16	Dastur Group
17	General Insurance Corporation of India
18	General Insurance Council
19	ILFS Brokers
20	Bajaj Capital Insurance Broking Services
21	FICCI
22	Agriculture Insurance Company
23	PHD Chamber of Commerce
24	Iffco Tokio General Insurance Company Limited
25	Mahindra Insurance Brokers
26	The Oriental Insurance Company Limited
27	Confederation of Indian Industry
28	Excellent Insurance Broking Services Limited
29	Birla Insurance Advisory Services
30	Embee Insurance Brokers
31	Principal PNB Brokers

32	United India Insurance Company Limited
33	Cholamandalam General Insurance Company Limited
34	SPT Park Brokers
35	Star Health & Allied Insurance Company
36	T T Insurance Services
37	Reliance Industries Limited
38	Indian Merchants Association
39	Kotak Insurance
40	Corporate Risk & Insurance Management (ESSAR Group)
41	Reliance General Insurance Co.Limited