

[Translation]
ISSUES PAPER



**AUTORITÉ
DES MARCHÉS
FINANCIERS**

**MANAGING CONFLICT OF INTEREST
RISK IN RELATION TO INCENTIVES**

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1. INTRODUCTION

The issue of how to manage conflict of interest risk in relation to incentives is a topical subject in the financial sector. The Canadian Securities Administrators (“CSA”) is currently examining several aspects related to conflicts of interest stemming from compensation arrangements and incentive practices.¹ The Canadian Life and Health Insurance Association (“CLHIA”) has also published a report on individual insurance distribution practices from the perspective of the consumer.² These documents all refer to remuneration practices with the potential for conflicts of interest, to the detriment of the fair treatment of consumers. A number of other bodies in Canada and elsewhere around the world are paying special attention to this issue. The ultimate objective of these initiatives is the same, i.e., protect users of financial products and services.

In addition, several years ago the CSA began its work on remuneration practices in the securities sector, focusing primarily on the obligations of investment fund managers, advisers, brokers and representatives.

As for the insurance sector, there is already some supervision of the obligations of representatives and firms.

Insurers, which are manufacturers of insurance products, but also develop incentive programs for paying the various intermediaries who offer their products, must also comply with the applicable existing framework.

The *Act respecting insurance*, CQLR, c. A-32 (“Insurance Act”),³ states: “Every insurer and every holding company controlled by an insurer must adhere to sound commercial practices. These practices include properly informing persons being offered a product or service and acting fairly in dealings with them.”

In June 2013, the *Autorité des marchés financiers* (the “Authority” or the “AMF”) published the Sound Commercial Practices Guideline (the “Guideline”) in order to communicate its expectations regarding results in matters of sound commercial practices. This Guideline applies to, among others, insurers governed by the Insurance Act.

In particular, the Guideline specifies that the AMF expects financial institutions to develop strategies, policies and procedures commensurate with the nature, size and complexity of their activities.

The Guideline also states that the AMF expects incentives not to affect the fair treatment of consumers. The term “**incentive**” is used in its broad sense and includes bonuses, commissions, salaries, premiums and fees in compensation programs, and other benefits (sales contests, promotions, perks, gifts, etc.).

¹ CSA Consultation Paper 33-404 - *Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives Toward Their Clients*, April 28, 2016; CSA Staff Notice 33-318 *Review of Practices Firms Use to Compensate and Provide Incentives to their Representatives*, December 15, 2016; and CSA Consultation Paper 81-408 - *Consultation on the Option of Discontinuing Embedded Commissions*, January 10, 2017.

² *Insurance Distribution in Canada: Promoting a Customer-focused System*.

³ Section 222.2.

Consumers must be confident that recommended products truly meet their needs. Similarly, the AMF expects incentives not to interfere with the obligation of the institution or any intermediary between the institution and the client to act fairly when dealing with consumers.

Insurers' practices related to the design and management of incentives must therefore take into account potential conflicts of interest during the sales process of a given product.

Conflicts of interest arise where a party has competing professional and personal interests. This includes soliciting or accepting inducements where this would conflict with the insurer's or intermediary's duties to its customers.⁴

Since issuing the Guideline, the AMF has adopted a step-by-step approach to raise awareness in the insurance sector about its introduction and enable the implementation of measures to achieve the expected results.

To gain an overview of insurers' progress in implementing the Guideline, in May 2014, the AMF sent a self-assessment questionnaire (the "self-assessment") to 219 insurers licensed to operate in Québec.

In July 2015, following an analysis of the information received, the AMF released the results of this self-assessment in a report entitled *Results of the Commercial Practices Self-Assessment – Insurers* ("Commercial Practices Report"). This report presents the findings for each of the eight themes of the Guideline.

Although based on a self-assessment, the analysis identified certain areas requiring vigilance, one of which was incentives management. Among other things, the self-assessment revealed that in many cases insurers' incentive systems were based solely on volume of written premiums. Moreover, some incentives listed were such that they created a risk of conflict of interest, e.g., sales contests targeting a given product.

In most cases, the AMF was not able to identify incentives that explicitly factored in the fair treatment of consumers. However, some good practices were reported, including suspending the payment of the incentive in the following instances:

- when the customer satisfaction objective is not reached;
- when underwriting rules or the code of conduct (which includes factors pertaining to the fair treatment of consumers) are not observed.

When the AMF released the Commercial Practices Report it announced that it would conduct work in the areas of vigilance identified, including the management of incentives in the insurance sector.

Therefore, over the past few months, the AMF analyzed all of the documentation gathered through the self-assessment exercise, as well as during individual meetings with members of the insurance industry and during supervisory and inspection work.

⁴ Insurance Core Principles (ICP 19.7.1).

2. PURPOSE OF ISSUES PAPER

This issues paper is another step in the process begun in 2013. Its purpose is to further discussions on the risk of certain incentive categories negatively impacting the fair treatment of consumers and on the control and supervision mechanisms that should be implemented to mitigate this risk. To do so, the AMF is addressing specific questions to industry stakeholders, and will use their answers and comments in its ongoing supervisory and inspection activities. If necessary, the work could also serve as a reference—similar to, for example, international core principles—when developing or reviewing frameworks. Similarly, a follow-up of consultations under way in the securities industry will continue.

This document therefore presents most of the incentives used in Québec, grouped by category. Each incentive category is then ranked by level of conflict of interest risk. This classification is based on an internal assessment of supervision using criteria determined by the AMF, as presented in section 5.

3. ANALYTICAL SCOPE AND METHODOLOGY

This issues paper covers the incentives paid by insurers to firms, independent representatives and independent partnerships (including third-party administrators involved in the product offering process) and certified representatives, for both insurance of persons and damage insurance.

The data used for the work resulting in this discussion come from the information and documents on insurer practices the AMF obtained from its periodic supervisory and inspection activities and the self-assessment. Using this, the AMF was able to construct an overview of current industry incentives.

4. INCENTIVE CATEGORIES

Many stakeholders can be involved in the distribution chain of insurance of persons and damage insurance products. The insurer may opt for direct distribution, the registrant network (firms, independent representatives and independent partnerships) and/or distribution through general agents and wholesalers (collectively referred to as “intermediaries” in this issues paper). All representatives and intermediaries involved receive incentives from the insurers whose products they distribute.

The AMF drew up a list of the main incentive categories from the information gathered, in order to rank them according to their conflict of interest risk based on certain criteria.

The incentives presented below pertain to both insurance of persons and damage insurance. For simplification, no distinction was made between the two sectors, although some incentives may apply to only one of the two sectors.

The AMF overview of insurance incentives does not include all terms and names used, since they can differ by industry sector, insurer, product, distribution method, etc.

4.1 Remuneration

4.1.1 Salary

Salary refers to the compensation received by persons bound by an employment contract. Employees of an insurer or a firm are generally paid a salary.

4.1.2 Fees

Generally set by the person or entity to which they are paid, fees are a type of remuneration paid to professionals by clients in exchange for services rendered.

Other terms used: service fees, compensation.

4.1.3 Commissions

Commissions are remuneration usually calculated as a percentage of the premium or amount invested. There are several types of commissions: They usually vary by type of insurance policy (e.g., permanent, term or universal life insurance; critical illness insurance; disability insurance; personal-lines and commercial-lines insurance), and by coverage options.

There are several types of commissions:

Upfront commission

The upfront commission is paid when a product is sold. It usually represents a percentage of the policy premium or amount invested and is generally paid once, when the policy is issued.

An upfront commission is earned by a representative or an intermediary, who retains it even if the client cancels the policy. How long it takes to earn the commission may vary based on the insurer and type of product sold. A representative or intermediary may have to reimburse the upfront commission received when the policy is cancelled before the commission is actually earned.

Other terms used for upfront commission: sales commission, brokerage commission, base commission, first-year commission.

Level commission

A level commission is an upfront commission spread over time. The commission is paid only once it is "earned." Therefore, if a policy is cancelled, the representative or intermediary keeps the portion of the commission that was paid to him or her by the insurer.

Trailing commission

Trailing commissions are paid to representatives or intermediaries for the ongoing services they provide to their clients. These commissions are added to upfront commissions. Trailing commissions apply only in insurance of persons.

Other term used: maintenance commission.

Renewal commission

Payment of a renewal commission depends, as its name indicates, on a renewal. The commission is paid to a representative or an intermediary when the policy is renewed with the same insurer.

4.1.4 Bonus

A bonus is an amount of money (fixed or based on a percentage of the premium volume, amount invested or commissions) paid to a representative or an intermediary as a reward or encouragement for sales performance. Bonuses can take various forms, such as:

Overriding commission

An overriding commission is paid on achieving a determined sales volume and is expressed as a percentage added to the upfront commission. In certain cases, the overriding commission aims to compensate a producer for increasing an intermediary's sales volume in a given geographic territory or business area, or for a specific type of product.

Retention commission

Retention commissions are paid to intermediaries and consist, for an insurer, in making the payment conditional on maintaining a certain volume of in-force policies. It may be paid annually by an insurer during a given number of years or for as long as the expected policy volume is maintained.

Growth commission

A growth commission pays an additional percentage based on the level of portfolio growth year over year. It is sometimes offered as a plan whereby intermediaries receive an increased commission percentage if they grow their business volume.

Profit-sharing programs

These programs are a form of supplemental compensation that applies based on the profits generated by a block of business. To obtain this remuneration, intermediaries must satisfy certain criteria in the representation contract over a given period of time. Frequent criteria include achieving a volume of new business or maintaining a customer retention rate or loss ratio according to a defined threshold. The chosen criteria differ from one insurer to another and the amount paid is based on a rate set out in the profit-sharing program or representation contract.

Other term used: contingent commission.

4.2 Other benefits

Contests

Contests are intended mainly for representatives and come in various forms. Some contests are intended to reward those who have achieved a minimum number of sales. Contest participation may also be completely random. Participants are chosen without taking the number of sales into account (e.g., representatives become eligible for the contest simply by making a sale). Prizes vary from cash to goods or services (e.g., show tickets, gift certificates, hotel accommodations, and attendance at conferences).

Other types of benefits

Other types of benefits were also reported, including:

- Access to privileged circles (e.g., president's club, gala event for the top salespersons);
- Use of an IT platform or software; and
- Client referrals from insurers (prospects from the insurer's website).

5. CRITERIA IDENTIFIED BY THE AMF FOR ASSESSING CONFLICT OF INTEREST RISK

According to the AMF, any incentive intended to stimulate, convince or encourage people to act in their own interests could interfere with the fair treatment of consumers if offsetting mechanisms are not in place. For the purposes of its analysis, the AMF ranked conflict of interest risk related to different incentive categories according to an internal assessment of supervision based on qualitative criteria.

Thus, incentives presenting one or several of the following criteria could encourage representatives or intermediaries to whom they are paid to put their own interests before that of consumers:

- The incentive is calculated only on premium volume or amount invested, and no other criteria promoting the fair treatment of consumers is taken into account (e.g., service quality or suitability of product sold).
- The incentive is triggered based on the achievement of a performance threshold (individually or as a group).
- The incentive is geared to the sale of a specific product or product category.
- The incentive is intended to promote the salesperson's reputation (top salesperson).

6. ASSESSMENT OF CONFLICT OF INTEREST RISK ASSOCIATED WITH INCENTIVES

Based on the assessment criteria for conflict of interest risk, the AMF has attributed a risk score to the various types of incentives identified above.

6.1 Low-risk incentives

6.1.1 Salary

Remuneration in the form of salary was considered a **low risk**, as it is usually fixed. It does not factor in account sales volume or performance and is not geared toward the sale of a specific product.

6.1.2 Fees and service charges

Fees and service charges are used infrequently in the insurance sector. They pose a **low risk**, since, like salary, they do not take into account sales volume or performance and are not geared toward the sale of a specific product.

6.2 Medium-risk incentives

6.2.1 Commissions

Commissions are used widely as remuneration in the insurance industry. Overall, upfront commission rates per product are quite standard throughout the industry. However, commissions are calculated only on sales volume, i.e., premiums. Moreover, a product for which the insurer offers higher commission rates could lead the intermediary or representative to promote the sale of this product, without it being the most suitable product to meet the client's needs.

This type of incentive was therefore assessed as a **medium risk** of conflict of interest.

6.3 High-risk incentives

6.3.1 Bonuses

Bonuses are clearly the most diverse form of incentive. They include many variants of paying representatives and intermediaries additional remuneration for product sales and all their work done in a reference year.

Bonuses are added to the base pay via commissions to which representatives and intermediaries are entitled under certain conditions. Some types of bonuses are more akin to a requirement by insurers to achieve a certain volume for a given year, e.g., growth commission. In all cases, the better the intermediary's performance, the greater and more lucrative the bonus.

For instance, profit-sharing programs (contingent commissions) are often very demanding in terms of targets and may influence intermediaries in the choice of products or insurer to propose to clients. These bonuses may represent large amounts.

Bonuses are directly linked to a premium volume and a performance threshold. Achieving a performance threshold puts pressure on representatives and intermediaries and, as a result, the AMF considers that bonuses represent a **high risk** of conflict of interest. Consequently, bonuses could lead to careless commercial practices. Representatives might be tempted to place their own interests before those of the client and recommend an insurance product that does not meet the client's real needs.

The AMF also believes that the accumulation of incentives may lead to prioritizing a specific insurer's products in order to earn greater total remuneration to the detriment of the fair treatment of consumers.

6.3.2 Additional benefits

Contests

As regards other forms of incentives, the most common appear to be sales contests. This type of incentive is usually tied to the sale of a specific product, to a product category or to a representative's performance. The more product sales a representative makes, the higher the chance of taking part in contests. To qualify for a conference or trip or to win prizes, representatives could be tempted to focus their production in a single area. The AMF therefore considers contests to be at **high risk** of conflict of interest.

Conference and travel incentives were addressed by the CLHIA in its report published on February 26, 2016.⁵ This report mentions that "in those situations where an advisor has a choice between various insurers, conference incentives could contribute to a perception of a conflict of interest."

Since the release of the Commercial Practices Report in 2015 and the CLHIA report in 2016, several insurers have discontinued sales contests involving trips and conferences, and indicated that they were reviewing their approach to this type of incentive. While this is a good start to managing incentives, the AMF considers that a comprehensive assessment of risk related to all forms of incentives should continue.

Other benefits

Membership in select clubs, the awarding of titles (e.g., sales manager), access to an IT platform or software, and client referrals are examples of other benefits that may prompt intermediaries to increase their sales volume to obtain the resulting benefit. In the case of titles, clients might believe that the representative earned the title because of his or her competence. The AMF therefore assesses this benefit as being at **high risk** of conflict of interest.

⁵ *Insurance Distribution in Canada: Promoting a Customer-focused System.*

7. QUESTIONS

To move forward with the discussion on the risk of certain incentive categories interfering with the fair treatment of consumers and the control and supervision mechanisms that should be implemented to mitigate this risk, the AMF is addressing the following questions to insurance industry stakeholders. The information gathered will allow the AMF, as part of its supervisory activities, to pursue its work in this area and observe current or recommended practices. This work could also serve as a reference—similar, for example, to international core principles—when developing or reviewing frameworks.

For each question, specify the details of the distribution method (direct distribution or registrant networks (firms, independent representatives and independent partnerships), if applicable.

- 1. Should other incentive categories be added to the list of incentives? Which ones?**
- 2. Which details could be added to the descriptions of the various incentive categories?**
- 3. In your opinion, does the risk assessment presented in this document by incentive category adequately reflect conflict of interest risk? If your answer is “no,” explain why.**
- 4. What other criteria could be considered to assess the risk of conflict of interest in relation to incentives?**
- 5. What mechanisms do you have or plan to set up to mitigate the risk of conflict of interest in relation to incentives:
(a) During the design and marketing of products?
(b) During after-sales follow-up?**
- 6. Do your policies and procedures prohibit certain incentives deemed at high risk of conflict of interest? Please describe these incentives.**
- 7. Do you establish maximum thresholds for the overall incentives to be paid to an intermediary? Please provide examples.**
- 8. Have you formalized specific criteria for sales contest awards in order to mitigate their risk of conflict of interest? If so, please specify what these criteria are.**
- 9. Do you have mechanisms in place to foster transparency in the disclosure of incentives to consumers? If so, please explain what they are?**

- 10. For incentive categories deemed at high risk, do you think that mitigation measures could reduce the risk to an acceptable level? Please elaborate.**
- 11. Do you think that the accumulation of incentives could present an increased risk of conflict of interest? Please explain.**
- 12. Given the consultations under way in the securities sector,⁶ do you believe that the insurance sector (overall or in certain subsectors) faces the same issues? Please develop and support your answer with examples and facts.**
- 13. Do you believe that incentives create a competitive imbalance between insurers of different sizes or, as regards investment products, between the insurance sector and the securities sector? Explain your answer.**
- 14. Do you believe that current incentive programs prevent product offerings that are more advantageous and less costly for consumers? Please explain your answer.**
- 15. In your opinion, which method of remuneration would most adequately mitigate conflict of interest risk?**

In line with the *Framework for Cooperative Market Conduct Supervision in Canada* of the Canadian Council of Insurance Regulators (CCIR), which is intended to foster greater collaboration and information sharing in the supervisory of market conduct risk in the insurance industry, CCIR members are interested in knowing whether the findings presented in this document could vary from other Canadian provinces.

- 16. Do you think that the incentives listed in this document are consistent across the provinces in which you operate?**
- 17. Are your mechanisms for managing conflict of interest risk associated with incentives consistent across the provinces in which you operate?**

⁶ CSA Consultation Paper 33-404 - *Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives Toward Their Clients*, April 28, 2016, and CSA Consultation Paper 81-408 - *Consultation on the Option of Discontinuing Embedded Commissions*, January 10, 2017..

8. CONCLUSION

The AMF is inviting insurance stakeholders to submit their comments and observations about the points raised in this issues paper.

An electronic copy of this document is available on the AMF website at <https://lautorite.qc.ca/en/professionals/insurers/>

Please send your observations by October 15, 2017, by e-mail to inc-form@lautorite.qc.ca or, for insurers holding a licence, via the secure File Transfer Service (user code beginning with ALXXXX and password). Documents must be saved with the prefix INC-XXXX.