

# INSURANCE

CHRONICLE

The Icfai University Press

- Captive Insurers
- Micro Insurance
- Know Your Customer

May 2007

[www.icfaipress.org](http://www.icfaipress.org)

Rs. 60

# Detariffing CHALLENGES AHEAD





# United Kingdom

## Insurance "Contract Certainty" Revisited

Benjamin Macfarlane\*

*The events of "9/11" shattered conventional thinking about insurance in a number of ways. A tricky debate has centered on the question of what cover had been provided for the Twin Towers at the time of the attack. After the World Trade Center collapsed, the leaseholder, Larry Silverstein claimed that there had been two events, based on the two plane strikes, while the insurers and reinsurers argued that there had been one event based on a single coordinated terrorist attack. It was out of this febrile atmosphere that a call came from the insurance market for greater contract certainty. And so the drive for clarity began, led by the FSA.*

The beginning of 2005 saw several changes in the London market. The regulator, Financial Services Authority (FSA) took charge of the general insurance business. Recognizing the need for standardization and security in an industry known for its informal practice methods, the FSA gave the market an ultimatum.

In response to the regulator's challenge, the market initiated a process of reform with various contract certainty governance groups consisting of brokers, members of Lloyd's and other insurance industry committees and associations. In April 2005, the Lloyd's market updated the existing (November 2003) slip and mandated a new slip form.

In September 2005, the non-subscription market working group launched its Contract Certainty Code of Good Practice. The insurance industry is required to make a substantial improvement in the degree of contract certainty that exists between an insurer and the insured by the end of 2006. In order to achieve this, the Association of British Insurers (ABI), the British Insurance Brokers' Association (BIBA) and the Institute of Insurance Brokers (IIB) have published a code of practice that became effective from October 1, 2005. The purpose of the Code is to make clear to policyholders, intermediaries and insurers the totality of coverage when General Insurance policies are inceptioned and renewed.

The overall objective of the contract certainty and documentation reforms is to achieve the prompt delivery of documentation evidencing coverage for the client. Although formulated as part of Lloyd's quality assessment processes, it is hoped that the London Market Principles (LMP) Slip will enhance the insurance market practice in general.

### Process for Ensuring Contract Certainty and the Formulation of the Slip

#### FSA's Role in the Process

Beginning December 2004, the market has been given two years by the FSA to adopt a certain standard in relation to contract certainty. Should it fail to meet this objective, the FSA will impose its own rules.

\* Principal, BJ Macfarlane & Co., London. The author can be reached at [b.macfarlane@bjm-co.com](mailto:b.macfarlane@bjm-co.com)

So long as the market delivers the aims and outcomes expected, the FSA has no preference as to how this end is reached. The FSA, however, wants to be a partner in the process and be kept informed of progress. It also wants to provide assistance and feedback where appropriate.

Market reaction has taken several forms, one of which has resulted in the issue of a Lloyd's standard slip form mandated in 2004<sup>1</sup> for the first time in over three centuries. There has been general support for the FSA's interest in the issue and also for setting a formal deadline for a solution.

Conscious efforts have been made to initiate a reforms process with the establishment of several groups to achieve this goal. Ultimate responsibility for the change has been given to the Market Reform Group (MRG), which consists of "movers and shakers", from the groupings making up the London Market: Lloyd's, London Market Association (LMA), Lloyd's Market Brokers Committee (LMBC) and the International Underwriting Association (IUA).

### The Need for Uniform Practice Rules

Identifying the gap in practice standards of the commercial insurance covers, the market set out to define "contract certainty"<sup>2</sup> and stated: "Contract certainty is said to be achieved by the complete and final agreement of all terms between the insured and insurers before inception of contract."<sup>3</sup>

The growing market recognition of the need for contract certainty was shown by the recently conducted "Lloyd's Annual Underwriter Opinion Survey"<sup>4</sup> in which contract certainty emerged as the second most important issue to underwriters in the London market.

There are several reasons why contract certainty has become a commercial necessity rather than merely an aspirational regulatory concept. These may be summed up as follows:

- Contract certainty is essential in order to minimize risk. This risk applies to underwriters and brokers. Underwriters are affected because they are uncertain with regard to their exposure, while brokers are exposed to Errors and Omissions (E&O) risk when wordings are unclear or non-existent.
- Uncertainty over exposure for underwriters leads not only to reserving risk but also to an inability to understand business performance properly and therefore pricing. Inability to calculate exposure properly leads to capital misallocation.
- Lack of contract certainty leads to delayed negotiations and legal disputes. These generate higher costs and slower movement of cash.
- Lack of contract certainty means that the policyholders do not have clarity of coverage, or documentation of it, when they purchase coverage.

### Lloyd's Adopts the LMP Slip

#### Contract Certainty and LMP Reform

Contract certainty forms one of the fundamental objectives of the LMP reform, intended to improve services to clients. Increased efficiency should help to retain existing business and attract new quality work to the London market. Contract certainty can be summarized as having the following aims:

<sup>1</sup> The Lloyd's slip form is a short form record of an insurance agreement done in the London market.

<sup>2</sup> For this purpose, it looked at the general definition provided by the FSA chief, John Tiner in a Speech at a Symposium in New York "Costs and Opportunities Related to Best Practices for Global Players; How Regulators will Respond to a Global Insurance Market" delivered on December 13, 2004.

<sup>3</sup> Recognized as an interim definition by the Market Reform Group (MRG).

<sup>4</sup> The Press Release issued for this survey was on April 20, 2005.

- To provide clarity with regard to contractual terms;
- To ensure certainty of coverage;
- To minimize disputes;
- To reduce time wasted;
- To reduce legal bills;
- To improve downstream processing.

In broad terms, the changes require the following attributes in any commercial insurance contract written in the London market:

- That the terms of the contract should be clear and unambiguous.
- That the law and jurisdiction and arbitration clauses should be clearly referenced and complete.
- That all duties in relation to the insurance cover are clearly allocated, including processing of contract changes, document production and claims processing.
- That it is clear what information was provided to insurers to enable them to assess the risk at the time of placement.

One aspect of the requirement for clear and unambiguous terms that has very recently come into the spotlight again is the issue of broker's commission. In a speech for the Insurance Institute of London,<sup>5</sup> John Tiner, Head of the FSA said that it was becoming "palpably clear" that there was "little chance of a market solution" over the issue of broker commissions. Further that: Authority would now take a "closer look at commission disclosure in our business plan for 2007".

## Conclusion

The MRC's first formal measurement in March 2006 revealed that 65% of the contracts agreed in December 2005 were certain against the requirement of 30%. The MRC targets are 75% by the end of September 2006 and 85% by the end of 2006. The non-subscription market working group has agreed to full compliance with its code by December 2006.

John Tiner (FSA Chief) has called on UK risk managers to do more to push for progress on contract certainty, announcing that regulatory intervention would be put on hold subject to review in September 2006. However, the FSA has expressed concerns about the quality, accuracy and currency of the data being collected by the market. It identified the following key objectives in the run up to September 2006:

- Critical analysis of the market and individual firm data to ensure that contract certainty is being achieved;
- Identification of the key factors inhibiting cultural change in the medium to long-term; and
- Evidence of progress in relation to legacy issues and milestones for reducing historic risks.

Over the coming months, the emphasis will be on maintaining the momentum and ensuring that firms are not just paying lip service to the notion of contract certainty but are actively implementing changes within their working culture and focusing on qualitative as well as quantitative measurement. ■■

Reference # 11M-2007-05-08-01

<sup>5</sup> October 2, 2006 in the Old Library at Lloyds.