

保險業監理處

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To : Chief Executives of all authorized insurers

Dear Sirs,

**Insurance Fraud**

On 28 October 2004, in response to a reported insurance fraud case involving a group of insurance intermediaries that affected several long term insurers, I wrote to you to remind you that, as chief executive and/or controller, you are responsible to ensure that your company has an effective internal control system in place to monitor the activities of your intermediaries and detect any irregular or suspicious behaviour.

**Monitoring of Intermediary Activities**

You are aware that last December, another suspected fraud case was reported to the Police for investigation. In this particular incident, the fraud scheme was detected by the long term insurer through its internal control system and the company took firm action by reporting the case to the Police. Early detection of the suspected fraudulent activities has helped the company to substantially reduce its potential loss. Experience shows that unscrupulous intermediaries are skilful to exploit the "soft spot" of the insurers, namely their reluctance to bring to light suspected internal fraud cases involving insurance intermediaries for fear that they may affect their image.

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As we all know, the way the insurance industry operates (relying on intermediaries to generate business) means that it is most susceptible to fraud. (Studies in some overseas insurance markets show that each year some 3% to 10% of premiums are lost through fraud.) Attempts made by insurers to conceal suspected fraud engaged by their intermediaries therefore will only help to embolden the offenders and jeopardise the industry. Since trust and integrity are the bedrock of the insurance industry, the Insurance Authority (“IA”) is firmly behind any action taken by insurers to report suspicious fraud to the Police. Insurers have a common interest to combat insurance fraud and are encouraged to share market intelligence so that other insurers can be put on alert and do not fall prey to fraudulent schemes.

### **Aggressive Commission Schemes**

A review of a number of suspected fraud cases involving intermediaries (agents and brokers) shows that such illegal activities are often associated with the aggressive commission schemes offered by insurers. In a highly competitive insurance market like Hong Kong, there is a great temptation for some insurers to take a shortsighted approach by offering excessively generous commission to agents and brokers (including the so called “golden handshake”) to seek to create new business or expand market share.

While the level of commission is a business decision of the individual insurers, as chief executive/controller, you are responsible to ensure that the commission policy of your company does not provide incentive or opportunity for unscrupulous intermediaries to engage in fraudulent or deceptive activities (and also other market misconduct such as twisting of policies). In addition to the level of commission, a loophole often exploited by intermediaries is the lax credit policy practised intentionally or unintentionally by some insurers. To maintain the integrity of your company and safeguard the interests of your shareholders and policyholders, you are accountable to the board for putting in place an effective internal system to regularly review your company’s credit policy and rigorously monitor the credit extended to your intermediaries for any irregular behaviour.

Specifically, your internal control system should be able to detect any excessive accumulation of credit, changes in repayment pattern, or abnormal increase in policy lapse rate of your intermediaries (including agents, brokers and general agencies) and give you early warning of any potential fraudulent activities. To help prevent insurance fraud and safeguard the integrity of the industry, we will in our future on-site inspection of insurers require the management to provide us with details of its system of managing and supervising intermediaries including the commission system and the policy of extending credit to intermediaries. We will need to be satisfied that the company has put in place an effective internal control system that is able to detect and prevent potential fraud committed by their intermediaries.

## **Conflicts of Interest of Insurance Brokers**

In respect of the management of insurance intermediaries, it has recently come to our attention that some insurers require those insurance brokers who maintain business with them to “comply with minimum production requirement” and / or offer incentive commissions / bonus to reward volume business. I should like to remind you that, as chief executive/controller of an authorized insurer, you should be fully aware that under the minimum requirements for insurance brokers specified by the IA and the code of conduct of their respective self-regulatory bodies, insurance brokers are required to act in the best interest of their clients including in particular to avoid any real or potential conflict of interests in their practice and in serving their clients.

As highlighted in a recent and well publicised case in the United States, any incentive or inducement provided by an insurer to seek to influence an insurance broker to place more business with it would jeopardise the independence of the insurance broker and is a serious market conduct issue. These prohibited practices include specifically (but not limited to) an insurer entering into a contract or agreement (exclusive or otherwise) with a view to inducing an insurance broker to place business with it by offering commission level based on volume or requiring an insurance broker to meet certain annual business target.

I should like to remind you that any insurance broker who engages in such relationship with an insurer is in breach of the code of conduct of its profession and will be subject to disciplinary action by its respective self-regulatory body. The insurer involved would be in conflict with the “fit and proper” requirement under the Insurance Companies Ordinance and would be subject to regulatory action. It is your own interest to ensure that your company does not enter into any business agreement with brokers which may be in breach of the code of conduct of the relevant brokers self-regulatory bodies or compromise their role to act independently and in the best interest of their clients.

Yours faithfully,

(Richard Yuen)  
Commissioner of Insurance

c.c. The Hong Kong Federation of Insurers  
Insurance Agents Registration Board  
The Hong Kong Confederation of Insurance Brokers  
Professional Insurance Brokers Association