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# IAA Risk Book Distribution Risks

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# **IAA Risk Book Distribution Risks**

**This Risk Book chapter has been developed and approved  
by the Insurance Regulation Committee of the IAA**

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## **Comment and feedback**

Comments and feedback on Risk Book chapters are welcomed.

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## **Version**

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## **Introducing the IAA Risk Book**

The actuarial profession has contributed significantly to the development of risk management tools and processes, in insurance, pensions and related industries. Actuarial skills are also increasingly being applied in new and developing areas of knowledge.

Actuarial practice continues to improve the understanding, measurement and communication of risk and risk events and their implications through the development of tools and increasingly processes to manage the future uncertainty of risks in a sustainable and transparent way. These tools and processes trace, manage and mitigate the acceptance and transmission of the uncertain outcomes of risks.

The Risk Book is intended to provide high-quality reference materials to support a better understanding of the risks and inherently uncertain future outcomes that need to be managed when delivering financial services products—whether they involve insurance, investments, or retirement incomes, or more broadly. The Risk Book is written to be accessible to a wide range of readers, many of whom may not be actuaries or experts in the areas discussed but may be decision-makers in those areas. Consequently, the Risk Book should provide insight into the ideas and concepts behind actuarial topics and concepts. It is therefore focused on being descriptive rather than being formal and mathematically precise.

All the Risk Book chapters are publicly available on the IAA website and are periodically updated. See [www.actuaries.org](http://www.actuaries.org) and follow the path to '*Knowledge / Publications / IAA Risk Book*'. A discussion of their structure and relationships is provided in the chapter '*Introduction – Using the Risk Book*'.

The Risk Book is intended to be a dynamic and evolving resource, updated over time, reflecting new areas where actuarial expertise can add value, experience and advances, and topics of current interest and importance. It is electronically distributed to support ongoing updates. Risk Book chapters will be reviewed periodically at least every 5 years and more frequently if significant changes or developments occur.

The development and maintenance of the Risk Book is managed by the Risk Book Editorial Board of the IAA Insurance Regulation Committee.

Many people, mostly actuaries, have contributed to the Risk Book. Contributors are listed on the website.

To submit comments or questions about this Risk Book chapter, or to report any problems with the website, please email [riskbookcomments@actuaries.org](mailto:riskbookcomments@actuaries.org). To express interest in becoming involved with the Risk Book please go to the website and provide the requested information.

## 1 Overview

### 1.1 Introduction

The complex nature of and public interest associated with many insurance products<sup>1</sup> make their distribution, and corresponding distribution risks, unique in several respects. For example, risks may arise with respect to life and health insurance that is sold rather than bought, and some property and casualty products may be compulsory or may be unaffordable.

Insurers set premiums for and underwrite insurance products that are marketed to a range of consumers. Purchasers of these products include individuals and businesses. Both insurers and their distribution channels (methods or processes of distributing an insurer's products) help ensure that the type, amount, and coverage features of sales or renewals of their products appropriately satisfy the insurance needs of their customers over what may be a long period. This assurance requires that insurers remain sustainable and continue to fulfill their insurance promises to their customers. In any case, the resulting distribution risks represent a responsibility of the insurer.

1. There are many marketing and distribution channels used by insurers, differing by market, coverage, country, technology, or historical development of the insurer. An insurer can conduct sales through one or more distribution channels, either (1) by agents<sup>2</sup> that represent a single insurer or multiple insurers or (2) through direct-to-consumer means, such as social media platforms, websites, mobile phones/texts, mail (post), or general advertising. Insurance can also be sold directly through partners (e.g., banks, micro-insurance institutions, and postal services) or other means (e.g., digital, phone, mail, or general advertising). An insurer can also utilize hybrid forms of distribution channels.
2. Agents and marketing organizations involved in the selling process can be compensated through commissions and/or incentive rewards, often a function of the premiums paid, assets under management, or loss ratio of a book of business, as applicable, or a pre-set salary, possibly supplemented by bonuses or other incentives.

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<sup>1</sup> In this chapter, 'life insurance' usually refers to life and health insurance and annuities for periods greater than one year. 'Group and short-term life insurance' includes life and health insurance sold for annual or shorter periods. 'Property and casualty insurance' is, in some countries, referred to as general or non-life insurance.

<sup>2</sup> This chapter uses the term 'agent' in a broad sense, including agents, brokers, agencies, and employees directly involved in selling insurance. In its Insurance Core Principle (ICP) 18, the International Association of Insurance Supervisors (IAIS) describes these as 'intermediaries.' They might also be a distribution partner or sponsor responsible for or otherwise involved in the distribution process, but whose primary business or occupation is not insurance and may not be licensed by the supervisor as an agent. They may be individuals or entities (e.g., a corporation or another form of business).

3. Agents involved in the sale of insurance policies, particularly those with a long coverage period that can be complex and involve consumer savings accumulation, are often compensated at a greater rate for new sales, usually through up-front or at least greater commissions early in the coverage period. They might also sell shorter-duration insurance policies, such as one year in length, which provide group and short-term life insurance, motor, property, and other casualty insurance coverage.

There are three primary forms of 'distribution risk':

1. Risks to a distribution channel. The viability of a distribution channel or an individual agent of an insurer is subject to a wide range of risks.
2. Risks to the performance of the insurer's insurance business. These can adversely affect the profitability, quality,<sup>3</sup> and volume of applicable insurance policies.
3. Risks to the insurer caused by the actions of a distribution channel or by the distribution process. These actions include mis-selling (i.e., selling an insurance policy that is inappropriate for the policyholder's situation), misrepresenting the coverage provided (i.e., the scope of coverages provided such as flood, prescription drugs, or cyber insurance), and moving books of business in a manner inconsistent with the policyholders' interests. These risks can result in decreases in the volume and quality of business, as well as its future sales capacity.

Insurance supervisors are concerned with the insurance needs of people and businesses operating in their jurisdictions. This concern is especially relevant because the consumer pays premiums up front and does not receive the benefit until a later time. The complex nature and perceived lack of transparency of many insurance products, as well as the relative lack of knowledge of consumers regarding insurance risks and policy features, have resulted in the need for consumer protection.

This has led to requirements for the licensing of insurance agents by supervisors, and in some cases regulatory review of insurance products and their premiums before their sale. Because of the risks of inappropriate sales and marketing practices, especially with respect to those who are not financially or insurance literate, insurance supervisors can be charged with oversight of product design and premium rates, especially relating to insurance coverage provided to individuals. This protection function can help ensure that insurance policies satisfy intended needs and that insurers treat their policyholders fairly. In addition, it can help

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<sup>3</sup> In general, 'quality' in the context of this chapter refers to either the appropriateness and fulfillment of the promises made in an insurance policy to the insureds or the profitability of the policy to the insurer. For many long-duration life insurance contracts, this can be assessed in terms of the persistency of the policy, measured by means of the equivalent of the 13th month premium payment to help identify who 'churns' business, or the non-renewal rate, and for short-duration non-life insurance contracts is often measured by the loss ratios for the past several years of experience.

ensure the sustainability of the insurance system and encourage individual insurers to fulfill the promises made to their policyholders.

For some insurers, the marketing process is viewed as encompassing all elements of the development, maintenance, and management of new business and continuation of the existing business of an insurer. This can include the design and pricing of its insurance products; growing, managing, and providing incentives for the insurer's distribution channel(s); and communicating with and educating its agents and its customers, as applicable. In contrast, the marketing function in other insurers may be distinct from the sales function, with a separate organizational structure devoted to overseeing operations that directly relate to the insurer's distribution channels.

A risk to a distribution channel can also represent a corresponding or consequential risk to the insurer, and vice versa. Therefore, it is important to assess these risks in the context of both the insurer and the elements of a distribution channel, as well as the associated insureds.

Some risks exist jointly, especially in the case of agents tied to a single insurer, whether as independent contractors or as employees. For example, adverse publicity can affect both the insurer and its distribution channel, caused by, for example, data risks (such as cyber or privacy-related risks, customer file hacking, or inadvertent incorrectly recorded transactions) or criminal activity (such as fraud). If trust in the industry is adversely affected, both the insurer and the insurance distribution channel are also damaged.

Although this chapter focuses on the risks associated with an insurer's distribution channel(s), the benefits of an effective distribution channel can be quite significant and necessary for the success and sustainability of the insurer and the insurance system. These risks and benefits can be assessed both qualitatively and quantitatively. Not only does a distribution channel(s) represent the source of ongoing business and in some cases provide customer services (e.g., policyholder service, claims management, and underwriting), but it can also serve as an effective mitigation tool against other business risks, through such functions as brand protection and promotion, and local relationship-building.

The appendix to this chapter describes some of the most common channels used.

## **1.2 Aim of This Chapter**

This chapter of the Risk Book provides the reader with an understanding of what distribution risks are and how they can impact the business of insurance. These risks are inherent in the delivery of insurance products to policyholders and should be considered key elements of the risk management process of an insurer.

## **1.3 Relevance to Actuaries**

Although some insurance or related products of an insurer are distributed directly to its customers, in which an agent is not involved, many sales involve a distribution process

involving an agent. As a result, actuaries involved in the risk management, product development, or pricing processes of insurers may also be involved in identifying, understanding, measuring, and managing distribution risks, as they can affect pricing and can ultimately affect the ability of insurers to fulfill the promises they have made. Examples of actuarial involvement in mitigating each type of distribution risk that has arisen in some countries are provided throughout this chapter.

#### **1.4 Executive Summary**

Each insurer uses one or more distribution channels to sell its products: insurance policies. These channels and their relationships with customers and potential customers can represent a significant intangible asset of the insurer. Nevertheless, the distribution process, including unintended and inappropriate marketing and servicing practices, can also pose a material risk to an insurer's sustainability and solvency, brand value, and income-generating potential.

The key messages of this chapter are:

1. Risks associated with its distribution system and marketing practices can lead to significant financial and reputational harm to the insurer, resulting in a reduced amount of new business or a deterioration in the quality of continuing business. This can in turn adversely affect its income, profitability, brand value, value as a going concern, and, in extreme cases, sustainability and solvency.
2. Risks can arise that adversely affect a distribution channel.
3. Some types of distribution risks may be categorized as operational risks, which are unpredictable and can represent significant reputation and financial risks to the insurer and its distribution channels.
4. Perceived concerns regarding the sustainability or brand impairment of an insurer can result in a rapid deterioration of the size and effectiveness of the insurer's distribution system.
5. Insurance supervisors can be charged with ensuring that the sales and service of insurance policies are conducted in a manner that delivers acceptable value to the consumer (i.e., market conduct oversight). Supervisory rules and actions can include a range of consumer protection requirements, such as suitability standards (so that the insurance coverage purchased meets the needs of the consumer) and minimum disclosure standards that can differ by jurisdiction. In some countries and for some products, actuaries sign off on the accuracy of illustrations of new sales or in-force insurance policies that explain the provisions (e.g., restrictions of coverage and limitations of guarantees) of complex or long-term products and provide advice on the suitability of sales to customers. Supervisors might also assess solvency-related



concerns with, for example, delegated insurance operational decision-making or fronting.<sup>4</sup>

6. The importance of distribution channel performance may require actuaries to be involved in estimating the quality of underwriting and sales, assessing policy performance in pricing insurance products, and helping to identify and measure distribution and conduct of business risks as part of the assessment of overall enterprise risk management (ERM).

Since a risk to a distribution channel can also represent a corresponding risk to the insurer, and vice versa, it is important to assess these risks in the context of the insurer and the elements of its distribution channel(s), as well as their insureds.

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<sup>4</sup> Fronting is the use of a licensed, admitted insurer to issue an insurance policy on behalf of a self-insured organization or captive insurer without the intention of transferring any risk. The risk of loss is retained by the self-insured or captive insurer through an indemnity or reinsurance agreement, although the fronting insurer would be required to honor the obligations imposed by the policy if the self-insurer or captive fails to honor it. This means that the fronting company retains credit risk.

## 2. Risks to a Distribution Channel

Given that effective and efficient distribution channels are crucial to the generation of future business of an insurer (including in some cases the profitability of existing business), risks to a significant distribution channel and its agents can in turn also become a substantial source of risk to the insurer. These risks are better addressed proactively to build and maintain a solid reputation.

These risks to the value and viability of a distribution channel include operational, strategic, and tactical risks related to continuity, concentration, and technology, such as:

1. A deterioration of agent continuity resulting from an aging sales force (for instance, in boomers who retired during the 2010s and 2020s) suggests that an insurer needs to periodically assess the demographic characteristics of its agents.
2. Skilled salespeople who may not be skilled as managers of field relationships and operations, but who are nevertheless chosen to serve as such managers (promotion risk).
3. The unfavorable reputation of agents due to past inappropriate or fraudulent sales practices or inappropriate incentives. But reputation risk can arise from many sources, such as adverse publicity generated by agents of other insurers, bad claim practices, government actions, or bad media relations. An adverse reputation event, such as a sexual harassment charge, can arise even if the agent is not found guilty.
4. New sources of competition to agents including mobile/Internet-based sales, or more intense competition within the same or different type of distribution channel.
5. Uncompetitive pricing, compensation, or support services.
6. Overconcentration of sales risk in a single or very small number of agents or customers.
7. Managing general agents, agents, or sub-agents that are more focused on generating high sales volume than on generating quality or profitable (to the insurer) sales, which in turn can lead to adverse financial results.
8. Inappropriate or ineffective use of technology, including social media or website design and capabilities. An example is if an insurer's policyholder data file is hacked (cyber-risk), not only might there be a loss of privacy and possible adverse consequences for its policyholders, but the agent's relationship with its customers would also likely suffer.

### 3. Risks to the Performance of the Insurer's Insurance Business

The distribution channel(s), target market(s), and underwriting guidelines used by an insurer can significantly influence the type and mix of its insureds, resulting in different expected insurance costs. When underwriting responsibility is delegated to the agent,<sup>5</sup> the nature and types of exposures to risk may not be as expected or intended by the insurer.

Areas of risk include the quality of insurance exposures covered compared to what is anticipated in the insurer's pricing assumptions, customer or policyholder behavior (e.g., applications not placed, terminations before the policy's expiry, and for some products, non-renewals by the policyholder), and the movement of entire blocks of business from one insurer to another.

The following risks can lead to adverse financial consequences for the insurer:

1. Risk selection. Often, but not always, agents directly or indirectly participate in the risk selection process by identifying potential customers and in some cases directly participate through assigned underwriting authority. In either case, anti-selection, policyholder moral hazard,<sup>6</sup> or even fraud by applicants can affect the underwriting process and profitability. In contrast to the objectives of the insurer, some agents may be more focused on maximizing their personal revenue than maximizing profitable sales. This is of particular concern with managing general agents who have been given significant autonomy concerning underwriting and managing their agents. If an independent agent splits its business between multiple insurers, the business directed to one of those insurers might be of worse quality, representing adverse risk selection against that insurer. In addition, if an agent gathers incorrect or incomplete information regarding the quality or risk characteristics of the potential insured, the insurer may consequently make incorrect underwriting decisions.
2. Policyholder behavior. In addition to potential moral hazard, policyholder behavior, such as the movement of business between companies to follow the lowest price

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<sup>5</sup> Sometimes referred to as field or agent underwriting. Field underwriting can be conducted by the agent or by someone at the insurer's field, regional, or branch office. It represents an agreed-upon delegation of this responsibility. Selection of potential insured risks by agents in the field, either judgmentally or in accordance with rules set by the insurer, is often confirmed by the insurer's underwriting staff, or agreed to by the agency and the insurer's underwriting staff. This can either be performed totally in the field or by the agent (or managing general agent) or as an initial underwriting screen to reduce the burden on or involvement of underwriting resources of the insurer. Delegated agent underwriting authority is more often given in the case of property and casualty insurance.

<sup>6</sup> Moral hazard can arise if an applicant or insured has an incentive to undertake or increase an exposure to risk not accompanied by the full cost of that risk; for example, not taking an action that could protect an insured property because the insured knows the insurance company will replace it if it is damaged or stolen.

offered in the market,<sup>7</sup> can result in large voluntary policy termination rates (sometimes referred to as lapses or surrenders in life and health insurance) or non-renewals relative to pricing expectations. This can impair the recovery of the insurer's acquisition expenses<sup>8</sup> or increase anti-selection against the insurer.

3. Agent incentives. Agents can influence the exercise of policy options that may not be in the customer's best interest.

For instance, in the case of some life/annuity contracts, the exchange of one policy for another is referred to as a replacement (when both policies are issued by the same insurer, it is called an internal replacement). Such an exchange may not be in the best financial interest of the policyholder, as it might result from an agent being incentivized by large front-end commissions from long-term insurance policies. A bulk (block) transfer of a book of property and casualty insurance policies on contract renewal might indicate the existence of a conflict of interest or mis-selling.

A conflict of interest could arise since compensation is paid by insurers for sales of insurance policies by agents. Such compensation may incentivize an agent to steer a sale toward a product that provides a larger amount of compensation, rather than a product more suitable to a customer's situation. It may occur where it is unclear whether the agent is working primarily on behalf of the insurer or the insured. In some jurisdictions, this has led to a greater use of fees payable by the customer for the service of the agent or required disclosures of the amount of compensation provided to the agent.

4. Policyholder interface. Ineffective and inconvenient policyholder interfacing or service, even when delivered through effective and modern technology (e.g., website, mobile phone, or toll-free call-in number), can adversely affect the persistency, policyholder retention, future sales, and profitability of the policies affected. It can also cause significant brand (and even industry) damage to an insurer and its distribution channels.
5. Agent termination. When an agent terminates its relationship with an insurer, especially in the case of longer-term in-force contracts or portfolios, the insurer determines how that agent's business (sometimes referred to as orphaned business) will be serviced. In some cases, it will be handled by another agent who can receive a servicing fee, a central administrative unit, or a phone-based help desk. The terminated agent could attempt to take the business to another insurer, which increases the

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<sup>7</sup> Although following the lowest price can in some cases inure to the benefit of the insured, it may also result in their long-term detriment if the 'new' insurer has significantly under-priced its products for short-term increases in business volume.

<sup>8</sup> A commission claw back provision is included in some agency contracts, more commonly when the agency does the billing and submits the result (net of commission) to the insurer.



original insurer's risks, such as inadequate expense recovery or being left with lower-quality business.

If insurer management or any element of the distribution system is focused on generating high sales volume at the expense of generating quality or profitable (to the insurer) business, adverse results, especially in the medium and long term, can result.

Actuaries regularly monitor and develop expectations regarding policy performance and policyholder behavior. Adverse experience in this area can be observed through high policy termination and low policy continuation rates, changes in agent retention, low claim approval rates, changes in sales volume, or high expense or loss ratios, all of which are typically reflected in premium rates and valuation assumptions.

However, if a relatively small volume of business is involved, the experience of agents is often assessed in the aggregate for multiple years, possibly by line of business, against benchmark targets. This can be tracked through internally generated experience studies and externally generated customer complaint data (e.g., from an insurance supervisor, an independent firm, or social networks). Complaint resolution metrics (by type, resolution percentage, and timeliness) can provide helpful feedback information to the insurer and insurance supervisor. As deviations from benchmark targets arise, the insurer should assess whether its expectations need to be revised, or corrective action is needed, with respect to the insurer's distribution channel or other elements of the insurance process.

Actuarial involvement in the assessment and application of these benchmarks with respect to their significance, credibility, and relevance can enhance the actuary's understanding of concerns of agents or applicable staff with the insurer's products and prices, as well as enable insurers to better identify the risks described above and develop or enhance the mitigation tools that can reduce the incidence and manage the severity of these risks. Actuarial involvement can also help identify distribution issues needing immediate insurer attention.

## 4. Risks to the Insurer Caused by Actions of a Distribution Channel or Distribution Process

The characteristics and quality of a distribution channel, and the effects of management decisions relating to its development and maintenance, can expose the insurer to risks in several ways in addition to their direct impact on the performance of its business as indicated in section 3.

Risks resulting from the operation of a distribution channel can include:

1. **Concentration risk.** This risk can take the form of overreliance on a single distribution channel, a few agents, or a few insureds. In the extreme, this can result from an overdependence by the insurer on a single agent or relationship that could (1) adversely affect or influence corporate policy, pricing levels, or underwriting decisions, (2) adversely affect profitability, or (3) significantly impact revenue if the relationship is terminated, possibly due to compensation less than a competitor's or if corporate or personnel decisions do not satisfy the agent(s). If, for example, a large portion of an insurer's sales are from agents located in a particular retail chain (such as a bank or department store), a decision by that retail chain to end the relationship could materially impact the insurer's financial position and plans.
2. **Outsourcing risk.** If the management of a distribution channel has been outsourced to an intermediary (e.g., to a managing general agent) or a partner (see partnering risk below), the insurer usually has a reduced level of control of the channel and its business. Although this may result in high acquisition costs because of relatively high commissions/fees to the outsourced entity, this may be offset by the cost savings resulting from the channel providing applicable services. The outsourced entity may be able to provide immediate scale or more rapidly recruit agents that in turn might be able to achieve higher sales volumes and access new markets. As a result, outsourcing may reduce overall unit costs partly because of scale or better technology, experience, or expertise. At the same time, such an arrangement could contribute to increased concentration risk. In any case, careful ongoing oversight and discussion may be required to overcome the loss of control.
3. **Partner risk.** This risk can result from a partnership with another firm to distribute the insurer's business, possibly with a bank (bancassurance), a retail network, or a micro-finance institution. It can be associated with the responsibility for various functions, such as distribution, allocated between the parties. The relationship involved can be similar to an outsourcing situation. However, the more parties involved in the acquisition and servicing processes, the greater the likelihood of inadvertent or unintended risks. In addition to the obvious risk of the bankruptcy of the partner, risks of misaligned motivation and incentives, ineffective coordination, and a lack of an exit strategy can result in harm to the insurer. If the partner is more concerned with

promoting itself than with the success/profitability of the insurance joint venture, both parties may ultimately suffer.

For example, if a representative of the partner sits on the board of the insurer, that representative might influence the decisions of the insurer to favor the partner or 'steal' the insurer's confidential information. To reduce this risk, many jurisdictions forbid agency firms to be represented on the insurer's board. In the case of a bank partner acting as a corporate agent, the partner could exert undue pressure and influence on the bank's customers to purchase insurance policies passed off as investment products. If inadequately monitored and managed, a potential for mis-selling and fraud exists, which would be bad for business in both the short and long term, representing brand and reputation risk for the insurer.

If the partner is responsible for collecting premiums, the insurer needs to ensure that these premium payments are made directly to the agent or other intermediary to avoid the risk that they might not reach the insurer.<sup>9</sup> This could result in a loss of coverage by the policyholder and, ultimately, damage to the insurer's reputation and possible litigation costs. In other words, delegation of authority does not delegate responsibility.

4. Sponsorship risks. Advertisements and sales can be augmented through the endorsement or other use of sponsors and brand salespeople, such as celebrities. As with any marketing effort, a deterioration in the reputation of the sponsor or celebrity can result in a significant reduction in the marketing potential or reputation of the insurer, although that might prove temporary if accompanied by timely action by the insurer.
5. Up-front compensation risk. Especially for long-duration life insurance sold to individuals, insurers in many countries pay significantly greater agent compensation at the time of a sale or volume-related additional compensation (e.g., a new business bonus or higher percent of premium if a target volume has been achieved) than at the time of policy renewal. On the one hand, this compensation can align the interests of the agent and the insurer, because a profitable product and long-term relationships can enhance capital/value for the insurer while providing capital to the agent to build and invest in its business. On the other hand, it can also adversely affect the sustainability of agents, as the agent can become overly dependent on new sales for cash flow and may not build up an adequate continuing stream of income.

This form of compensation can also create a conflict of interest as a result of an over-emphasis on placing new business and on moving (replacing) blocks of business between insurers or between products of the same insurer. A reduced ability for the

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<sup>9</sup> This risk also exists for agents who are not partners.

insurer to recover acquisition expense, moral hazard, and, in an extreme case, fraud, are also potential types of up-front compensation risk.

Whereas the insurer has an interest in retaining policies and policyholders to help ensure recovery of its up-front costs, up-front compensation can reduce the incentive for the agent to keep a policy in force, increase the incentive for selling policies with higher compensation, and churn, perhaps in a serial manner, the policy with one that may not be in the policyholder's best interest.

6. Cost recovery risk. Adverse sales results relative to those inherent in pricing assumptions can lead to reduced profitability due to inadequate recovery of fixed costs. This can result from a reduction in distribution channel productivity or effectiveness, or inaccurate actuarial estimates. Impaired cost recovery results from greater than expected fixed or non-variable expenses, a low level of business, or greater than expected rates of policy lapse or non-renewal.
7. Rogue agent risk. In some instances, an individual agent could act in a manner inconsistent with an insurer's policies and rules or collude with a third party to take advantage of the insurer, an insured, another party, or society. The action might be illegal, such as modifying an insurance policy without the consent of the insurer, charging unauthorized fees, intentionally misleading insureds, or acting fraudulently. Such action, once identified and reported to the supervisor or communicated to the public, can cause irreparable harm to the insurer's brand/reputation and be quite costly. Careful ongoing assessment of the insurer's reputation by geographic area may help pinpoint a problem with an agent. Depending on the type of business involved, this might be identified through monitoring of the experience of individual agents' business for early lapses, poor placement rates, low profitability of the agent's book of business, customer surveys, or mis-sold policies. An insurer can inquire of companies that previously employed the agent or applicable supervisors whether a prospective agent has previously been terminated with cause.
8. Mis-selling risk. The entire distribution system or part of it could sell one or more products in a manner that is unsuitable for the applicant(s). This mis-selling and other customer-related risks can expose the insurer to the potentially significant costs of having to assess and pay out redress, as well as regulatory fines and reputation risk.
9. Agent tax status risk. In some countries, the tax status of agents might change retroactively (e.g., from being an independent contractor to an employee), possibly resulting in considerable tax payments, penalties, or other costs for the insurer and restructuring of its distribution strategy.
10. Technology/regulation-related risks. A new technology or new regulations can make the current distribution process irrelevant or overly expensive compared to peers. An example is the use of new mobile phone apps to purchase or pay for insurance. A new

regulation could require additional continuing education requirements or fiduciary responsibilities, which may result in greater than expected costs (possibly offset by better quality business) or an inability to recover previous sunk costs.

11. Cyber and privacy risks. If an insurer's or agent's client data file is hacked (cyber-risk), not only will there be a loss of policyholder privacy and possible adverse consequences for the policyholders involved, but the insurer's and agent's relationships with their customers may also be adversely affected. This can also result in fines from data protection regulators. Concerns with privacy rules may impede the ability of insurers to use specific direct marketing channels. In any case, privacy rules and cyber concerns need to be addressed proactively.
12. Uncollected chargebacks. Sometimes, commissions are charged back to an agent out of future commissions if long-duration policies lapse in their first policy year. However, if an agent severs its relationship with the insurer, such a chargeback may become uncollectable.
13. Ponzi risk. Although relatively rare in insurance, multi-level marketing might occur through a Ponzi or pyramid scheme, in which a major element of compensation to agents includes a bonus for recruiting additional agents. Banned in several jurisdictions, this structure can provide short-term benefits to the agents initially involved in the scheme; it often eventually ends badly for all affected.
14. Bribes or kickbacks. A serious reputation risk may arise if a significant bribe or kickback occurs. For example, this will arise if the agent shares commissions with the customer. This is more likely if a large commission is payable and usually takes the form of cash or other monetary equivalent.

With management time and resources usually devoted to the growth of the business and market share, a lack of attention or weak governance with respect to the risks associated with its distribution process and channels can weaken overall insurer performance. This can be the result of top management time and resource over-allocation to what appears to be top agents. In any case, care is needed to ensure the agent or distribution channel does not benefit at the expense of policyholders.

Especially if the agent involved is tied to a single insurer, an adverse reputation event, such as a sexual harassment charge against the agent, may lead to adverse publicity that could also affect the insurer.

For an existing relationship between agents and an insurer, the number, quality, and cost of agents, especially involving important or sensitive products or sectors, require regular monitoring, with problems addressed promptly. Early indicators of problems can include unexpected changes in new business or market share, changes in not placed or lapse/continuation rates, high loss ratios (in non-life insurance), outsourcer fees, credit deterioration, or unacceptable behavior of agents. Regular open discussions with agents can

provide insight into the underlying short- and long-term reasons for such changes, which can lead to corrective actions, as appropriate.

Not only should the expected level of costs and benefits of a distribution channel be considered, but also their associated uncertainty, especially as they relate to the fixed costs involved, commitments made by both the insurer and the agents, and estimates of applicable business volume and quality. This may lead the insurer to re-assess its compensation and pricing strategies considering the cost and success rates of factors such as agent recruitment and sales. The quality and quantity of management and resources needed to achieve acceptable rates of success and the expected effectiveness of oversight may also be key factors to consider.

Actuaries are often involved in assessing and estimating the quality of sales and policy performance in pricing and valuation processes, as well as in the management of the above-described risks and distribution strategy performance. The effectiveness, accuracy, and regulatory compliance, whether in sales material, presentations, policy illustrations, websites, or mobile phone apps, can be pre-screened or audited, depending on the company and coverages offered. Although not normally directly involved in agent training, actuaries can be involved in the development of educational material regarding the products and the needs they address.

## **5. Consumer Protection/Market Conduct Risks**

Insurers owe their policyholders a duty of care, which extends beyond simple compliance with laws and regulations. Whether relations with their customers involve agents or other touchpoints, insurers need to manage their distribution and selling risks in a financially sound manner with their policyholders in mind.

Because of the service provided and consequential risks, protecting consumers against inappropriate market conduct should be quite an important factor in the insurer's marketing and management of its distribution channels. As such, it should be addressed as an important component in the insurer's risk management processes. A culture of fair business conduct by both the insurer and its distribution channels, responsible pricing, and appropriate claims management are key elements of an insurer's risk management.

Excessive distribution channel costs, including compensation, may reduce the net value of products sold by that distribution channel if the insurer passes these costs to the consumer (e.g., in privatized pension products sold earlier in certain Latin American countries).

### **5.1 Role of the Supervisor**

In addition to ensuring that contractual promises made by an insurer are fulfilled, insurance supervisors are often charged with ensuring that policyholders are treated fairly and are sold policies that meet their insurance needs. This is accomplished through regulatory standards and supervision of insurers and agents within the supervisors' scope of responsibility. In some jurisdictions, this supervision is conducted under the same supervisory authority as that charged with ensuring the solvency of insurers, while in others, it is performed separately.

In some cases, supervisors regulate and monitor certain aspects of rates, products, and agents, particularly those relating to the sale of insurance to individuals. This can be done, for instance, in areas such as rate and policy form approvals, minimum standards for policy benefit illustrations and disclosures (primarily for life, health, and annuities), clearly stated policy coverage provisions, remuneration limitations, and agent licensing.

Insurance market conduct supervisors are responsible for overseeing a wide range of conduct-related issues. These include ensuring that sales of insurance policies are conducted in a manner that delivers acceptable value to the consumer. Infractions can result in consumer protection remedies, including substantial fines (especially when a pattern of misconduct has been found), compensation to insureds, and required changes in company behavior, covering areas relating to policy features, underwriting, distribution, and claims.

Since the distribution system plays an important role in the effective delivery and servicing of insurance policies, insurance supervisors are concerned with the actions of the distribution system in the solicitation of new customers and servicing of existing customers. This has led

to licensing requirements for insurance agents to help ensure that they achieve and maintain an acceptable level of knowledge of insurance policies and insurance and financial needs.

However, supervisors in less developed jurisdictions may not have adequate resources, rules, or ability to monitor their insurers and agents for non-compliance. In addition, the regulation of the distribution of insurance products may fall in the cracks between supervisors with specified responsibilities—for example, between industries or products such as those intended for savings purposes. Finally, in some cases, not all those involved in the selling process may be required to satisfy minimum knowledge and experience in the insurance area.

In response to situations where insurance policies have been mis-sold to consumers (i.e., they are demonstrably unsuitable to satisfy a particular consumer's needs), some supervisors have adopted and enforced consumer protection rules and, when not followed, redress.

Examples of mis-selling include pension mis-selling in the United Kingdom, selling a payout annuity to someone seriously ill, providing inappropriate tax advice or a policy designed to illegally avoid a tax rule, and selling far more insurance than is needed solely to receive greater commissions. These practices may arise from the desire for more compensation by the agent or business volumes by the insurer.

An example of inadequate advice arises if insufficient or misleading disclosure of insurance coverage is provided, such as an absence of disclosure that a personal property policy does not provide coverage for flood or earthquake risks, even though the insured has material exposure to such hazards.

In some jurisdictions, there has been a move toward increased disclosure of agent compensation that has led to the use of fees charged to the policyholder rather than or in addition to compensation provided by the insurer. Advocates of this change have claimed that this will incentivize more objective advice. Due in part to concern with potential conflicts of interest, other supervisors have capped agent commissions at a certain maximum percentage, possibly as a function of services provided, banned or restricted certain commissions or other incentives, or required disclosure of commissions received.

In several areas, supervisors have limited the expenses of insurers, particularly relating to the sales and first-year expenses of individual life insurance. For example, the state of New York in the United States has limited compensation to agents by policy duration and aggregate limits for direct compensation and other types of selling expenses. Its intent is to help ensure that life insurers provide adequate value to consumers. In the United Kingdom, another attempt taken is a review of 'value for money' for certain life and pension products.

## **1.2 Risks to the Insurer**

Insurers are subject to conduct of business risks.<sup>10</sup> Effective risk management consists of operational (process) and strategic (determining the business model followed, including distribution and marketing objectives) elements. A key element of effective management is early identification and avoidance of inappropriate market conduct, which can lead to or suggest a future lack of sustainability and sound financial condition, which in turn could lead to prudential solvency risk. In addition, the existence of these risks may represent a symptom of ineffective corporate or marketing governance and a lack of internal controls over an insurer's distribution process.

Inappropriate market conduct and lack of consumer protection can result partly from an asymmetry of knowledge regarding insurance and insurance policy features that can be quite complex. This asymmetry is presumed to be more pronounced where the buyer is an individual (such as in the purchase of individual life insurance, micro-insurance, and personal property insurance) rather than where the buyer/sponsor is a commercial enterprise (such as in the case of group insurance, commercial property and casualty, or reinsurance). This concern may especially arise in less developed markets and jurisdictions. The greater the potential asymmetry of information, the more consumer protection may be needed.

Risks relating to a failure to adhere to regulatorily-mandated or generally accepted behaviors, particularly if an insurer or its distribution channels take advantage of this asymmetry to the detriment of customers, represent examples of market conduct risks. Some financial services companies, especially but not exclusively banks, have incurred large fines due to inadequate management of conduct risks.

Depending on the product and market, actuaries may be involved in the design of insurance products to help ensure that not only are premiums developed with the specific coverages in mind, but also that both the coverages provided and any of their limitations are clearly disclosed. This is particularly important where the insured maintains the investment risk, where there are benefit deductibles, exclusions, or potential rate increases, and where the policyholder may not understand all available benefits and options.

There are notorious situations in which policy 'fine print' includes coverage exclusions that may be inconsistent with policyholder expectations. This can arise where policies exclude coverage in certain circumstances, such as health insurance policies with a provision 'buried' in the middle of a long insurance contract indicating that there is no coverage for a pre-existing health condition. These expectations should be based on effectively delivered

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<sup>10</sup> Risks to customers, insurers, or the insurance industry that arise from the business of insurance. These risks arise in the course of the development, distribution, and management of insurance products in a manner that may not treat or appear to treat customers fairly. These can include mispricing (e.g., charging premiums that are discriminatory, use of non-filed rates when rates are required to be filed, or misapplying rating plans), mis-selling of life insurance coverage, and inappropriate claims handling. For further discussion, see the IAIS [Issues Paper on Conduct of Business Risk and its Management](#).



coverage information. Up-front disclosure is always preferable to post-claim denial. These situations may result from inadequate agent communication, pointing to the need for proper education of agents regarding insurance products they sell, ineffective competition at the consumer level, or a lack of informed choice.

In some jurisdictions, the content of policy benefit illustrations of life and health insurance policy performance is highly regulated, while in others, it is primarily self-regulated. If a supervisor penalizes an insurer because illustrations are inaccurately prepared or inappropriate for the customer, the cost of redress and reputation risk can be considerable. Actuaries may be involved in preparing the values and descriptions in policy benefit illustrations to help ensure that these illustrations are objectively and accurately prepared and are accompanied by understandable and accessible information.

User-friendly educational information and clear and concise disclosure suitable to the market concerning the workings of insurance provided by insurers, agents, supervisors, schools, or the media can help mitigate information asymmetry and enable consumers to make well-informed insurance decisions. The sophistication of disclosures through a distribution channel should be tailored to the knowledge of the expected users. This approach is equally applicable whether by means of a face-to-face sale or a sale through an insurer's or a third-party's website.

The geographic distribution of agents can lead to charges of unfair discrimination, which could result in reputation risk. A similar charge could be made if premiums are excessive relative to the expected costs of a market segment, such as in poor neighborhoods or where certain racial/ethnic groups are concentrated. This can also contribute to a lack of or gaps in these market segments' insurance penetration and insurance protection. Although the insurer may desire to avoid these relatively high-risk areas, insurance supervisors may not allow this practice.

Insurers, through a range of techniques, can provide consumer protection while managing sales and distribution-related risks. For instance, their controls can include:

- initial agent screening and training;
- continuing education programs regarding product features, their limitations, ethical sales techniques, and sales process rules and requirements;
- agent compensation and sales targets that consider implied incentives;
- timely agent discipline;
- periodic audit of sales processes;
- legal review of all advertising and sales promotional material;
- assurance that privacy rules are understood and satisfied;



- customer and policyholder satisfaction surveys;
- consumer education programs;
- an independent sales, customer, or policyholder ombudsman function; and
- incorporation within the insurer's risk management processes.

## 6. Conclusion

Distribution and marketing-related activities can result in significant financial risks to an insurer, as well as to its policyholders. Inadequate management of an insurer's distribution channels and its agents can lead to adverse consequences for an insurer's sustainability, brand value, and income-generating potential.

Insurance supervisors are concerned with inappropriate sales and advice, unacceptable market conduct, and provision of insurance functions, such as underwriting and claims practices, in a manner not in the best interest of consumers. These can require consumer protection and consequential action against an insurer and/or its agents, affecting the ability of the insurer to operate as a going concern.

Sound management of distribution risks will enhance and help maintain the value of and trust in the insurer. It should be incorporated as an important element of an insurer's overall risk management processes. These risks can be mitigated by using such methods as:

- regularly monitoring key performance indicators of individual agents, intermediaries, and distribution channels, including the number and type of customer complaints, retention rates of written business, surges in sales not seen industry-wide, sudden deterioration of loss ratios (non-life insurance), and indicators of possible fraud in new business;
- use of actuarial standards for suitable policy benefit illustrations of long-term products;
- agent and consumer education regarding consumer needs for the insurer's products and adequate and relevant disclosure regarding the extent of coverage provided;
- an independent and accountable function (such as the risk management and ombudsman functions), including the monitoring of sales practices and suitability processes that ensure that the coverage purchased meets the needs of the customer and their risks; and
- adherence to regulatory requirements that govern market conduct and sales practices, as well as regular reviews that assess the effectiveness of the insurer with respect to disciplining/educating/managing its distribution systems.

## Appendix: Types of Distribution Channels

There is a wide range of distribution channels in use by insurers, the relative importance of which depends upon the market, coverage, available resources, technology, and historical development. An insurer can utilize multiple channels—in some cases, one distribution channel is used for each business unit. In contrast, some business units utilize multiple distribution channels and some distribution channels can service multiple business units.

An agent usually serves as an intermediary between the insurer and the insurance policyholder (usually the insured). The agent can be an individual or a group of individuals (agency). An agent can specialize in a particular type of insurance product or sell many types of insurance. In addition, an insurer may use a combination of these channels in a particular market, for example, through leads generated by direct or website contacts, followed up by direct contact by independent agents or insurer employees. Insurance can also be distributed on a direct basis (e.g., through the mail, phone, or website). Whenever personal information is shared with or provided to a third party, the insurer must ensure that applicable privacy rules are complied with.

Differences between types of agents can arise because an agent may be viewed legally as representing only one of the parties, typically the insurer, in contrast to a broker who may lawfully be viewed as being more independent, possibly maintaining a level of fiduciary responsibility to the potential customer. ICP 18.0.13 indicates that:

- Where the intermediary acts primarily on behalf of the insurer and sells products for, and on behalf of, one or more insurers, they are often referred to as “agent” or “producer”. Intermediaries may act for a single insurer (sometimes referred to as “tied”) or several. The products they can offer may be restricted by agency agreements with the insurer(s) concerned.
- Where the intermediary acts primarily on behalf of the customer, the intermediary is independent of the insurer(s) whose products he sells. Often referred to as “broker”, or “independent financial adviser”, they are able to select products from those available across the market.

As a result, many jurisdictions differentiate between the requirements of intermediaries defined in the applicable supervisory framework as agents and those of brokers.

A distribution channel may utilize more than one distribution approach or a hybrid channel. For example, a full-time career agent may be an employee of an insurer or independent, and a sale may be initiated through contact with a website, with questions answered or the final sale made by an agent. The following is one categorization of distribution channels:

1. Full-time (tied or captive) career agents. They can be employees of an insurer or independent contractors who represent a single insurer, and are primarily involved in selling that insurer’s products. The classification as an employee or independent contractor can result from tradition, tax laws, or work rules. Subsidies can be

provided to a new agent for an initial period to allow for the training and development of customer contacts.

2. Salaried employees. They sell products directly on behalf of the insurer. This approach is often used in sales to large accounts—for instance, selling group life/health or commercial property and casualty insurance to large corporations or to direct insurers in the case of reinsurers. Their salaries can be fixed or can include incentives/bonuses as a reward for a successful amount or the profitability or quality of new sales or business.
3. Independent agents. They are not employees of the insurer. They can be brokers, who often represent multiple insurers, or who only sell insurance provided by a single insurer. Their primary business or occupation may or may not be to sell insurance products, such as being a wealth manager or real estate broker.
4. Consultants. In some market segments, particularly those consisting of high-income individuals or businesses, consumers employ specialist consultants or advisers to help them select between competing insurers and products. Regulators can differentiate between agents remunerated solely by the customer and independent agents, referred to above, who have traditionally been remunerated primarily by the insurer. Some insurers' distribution risks diminish if the gatekeeper to the customer is remunerated by the customer rather than the insurer, while other risks increase, such as the risk of falling out of favor with leading consultants or being less competitive in that market segment.
5. Partners. Sales can be generated by or as a result of a partnership with a firm that would not otherwise specialize in selling insurance or the insurance of the type sold. This can involve working with partners or sponsors, sometimes with an existing network. In some cases, they may not be licensed as insurance agents. This may provide an entrée, possibly in the form of bundled products, to potential customers they would not otherwise be able to access.

In some jurisdictions, a prime example is bancassurance, which involves a partnership between an insurer as the underwriter and a bank as the sales channel in the form of an affiliate, partner, or distributor of the insurer's products. Other examples of partners include retail chains, telecommunications entities, micro-finance institutions, trade unions, and post office outlets. Insurance sales can be developed in the following ways:

- as a consequence of, or coordinated with, the sale of related products, for example, with financial institutions (e.g., mortgage or warranty insurance) at the time loans are provided or with mortuaries (e.g., pre-need insurance) in anticipation of future burials;

- with insurers that specialize in other types of insurance—for example, sales of life insurance by a company that primarily sells property and casualty insurance; or
  - as part of a broader portfolio of products, for example, coordinated with other financial institutions or asset managers, especially for wealth management products such as annuities, pensions, life insurance, savings products, and loans. It can be sold by employees of the financial institution or by the insurer’s employees embedded in that company’s operations.
6. No agent involvement. Many distribution channels do not involve or require the use of sales representatives of an insurer. In some cases, an agent specializing in insurance may become involved in providing advanced advice or closing the sale. These include:
- Website. Sales can be made using a website, often to customers searching for a suitable insurer, a particular insurance product, or the lowest-priced policy. In some jurisdictions, an increasing percentage of customers shop for insurance through the websites of individual insurers, and sales can be conducted through the Internet, for example, based on price comparison websites<sup>11</sup> (PCWs). However, this method of distribution may not provide adequate advice concerning the extent to which the insurance policy is suitable for the individual or meets the real needs of the customer. Although this may increase the risk that a customer decides on a policy solely based on price, rather than the insurer’s financial soundness and service quality, customers can be directed to an agent to help satisfy this concern. Customer satisfaction and rating surveys can provide helpful information.
  - Social media. General or targeted advertising on social media platforms can direct a potential consumer to an insurer’s or agent’s website.
  - Mobile phone. Insurance is sold through or with assistance from a mobile network application (app) or operator. This means of communication can in some cases and coverages allow applications to be submitted and premiums to be paid, and provide customer service information. This approach is increasingly common in Africa, often in the form of micro-insurance.
  - Advertisements. Usually, this marketing method aims to attract consumers to a particular company and its agents, which can then serve as the first step in the sales process. Ad placement can be done through methods such as billboards, television, or social media. It can be aimed at either enhancing an insurer’s

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<sup>11</sup> In the European Union, the Insurance Distribution directive considers PCWs to be insurance intermediaries.



brand or enticing potential customers to inquire about the insurer's specific products through an agent or a website for further directions or a direct sale.

- Direct. Sales through this approach can be made through the mail (post), phone solicitation, or alternative technologies such as an insurer's or agent's website.
- Affinity/loyalty. Sales are made through an affiliation of the customer, for example, as a member of an association, labor union, or cooperative, or through a workplace scheme. Current insureds can represent an ideal source of future sales or renewals, usually less expensive to attract and possibly with a known insurance record.

Some insurers purchase blocks of insurance business from another insurer, possibly through the acquisition of an entire insurer or the use of an investment banker. In some cases, this block of business or insurer is put into a run-off mode—that is, the distribution system previously used to produce business does not actively pursue new business for the insurer. Not only are the normal risks associated with deviations from expected experience considered (e.g., policyholder behavior, mortality, or loss ratios), but if inadequate due diligence was performed, they also might include the cost associated with such risks as earlier mis-selling or misrepresentation committed by prior management or the original agents.

A managing general agent is a company or agency that controls the means of distribution, usually utilizing multiple sub-agents. In some cases, its services are provided in return for additional compensation for taking responsibility for specified marketing or other servicing functions, such as underwriting, rating, policyholder service, and claims, that otherwise would be handled or managed by the insurer.



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