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**The Regulatory Landscape and Market Overview of  
Insurance Agents and Brokers in the Czech Republic**

MA thesis

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Date: 29<sup>th</sup> of March 2018

**Declaration on Honour**

Hereby, I declare that the following MA thesis is my own work for which I used only the listed sources and literature, and that this thesis has not been used to acquire the same or another type of diploma. Further, I declare that the body of this thesis including footnotes amounts to 125 205 characters with spaces.

In Prague, 29<sup>th</sup> of March 2018

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Štěpán Veselský

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## **Introduction**

The insurance undertakings make use of multiple distribution channels in the course of reaching a prospective policy holder with an offer of a particular insurance product. The multiplicity of channels stems from the need to penetrate various customer segments and, to a lesser extent, address the specificity of different product lines. The individual distribution channels, unlike the insurance product lines, are not framed within any regulation and are a result of the market mechanisms. However, the legal and natural persons who are distributors of insurance by the virtue of their occupation, thereby giving substance to the distribution channels, are, partially, subjected to legislation.

The thesis is submitted in a time when the Czech legal framework, governing distributors of insurance, is expecting a fundamental change as the current applicable law – the Intermediaries Act<sup>1</sup> – is about to be superseded by the governmental proposal of the Insurance Distribution Act<sup>2</sup> in the second half of 2018 at the latest. As a major novelty, under the latter act, essentially all the distributors of insurance fall under its ambit, the categories of insurance distributors are rethought and their obligations are stepped up and extended. The adoption of the new law will cause a revolution along the whole insurance value chain: from insurance undertakings to insurance distributors and, ultimately, to consumers. The scope and imminence of the transition, along with my professional background as an analyst in the advisory company with insurance practice, encouraged me to undertake this research project into the subject matter.

The thesis aims to give a qualitative and quantitative understanding of this transition from one regulatory landscape to another. For that end, one has to have a firm grasp of the present situation in order to be able to appreciate and envisage the forthcoming change. I intend to achieve this aim by accomplishing the following objectives. At first, I will undertake a segmentation of a gross written premium in the Czech market into product lines that would be familiar to consumers, distributors and insurance undertakings. Then, based on market intelligence, I will outline my own distribution channel framework

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<sup>1</sup> Act 38/2004 Coll., Act on Insurance Intermediaries and on Independent Loss Adjusters and on Amendment to the Trades Licensing Act, as amended

<sup>2</sup> For full text see Apps.odok.cz [online]. 2018 [cit. 2018-02-17]. Available at WWW: <<https://apps.odok.cz/veklep-detail?pid=KORNAKEFEG4P>>.

within which distributors channel the premiums from consumers to insurance undertakings. Afterwards, at the heart of the thesis, I will analyze which distributors fall under the Intermediaries Act and interweave the learnings with my framework of distribution channels. Finally, I will give my findings a quantitative dimension by estimating the number of active distributors recognized by the Intermediaries Act. That would give a holistic understanding of the current situation and serve as a point of departure to the following analysis of the proposed Insurance Distribution Act. In assessing the new regulatory regime, I will focus on the novel categories of distributors and re-examine the distribution channels framework in light of the extended scope of the regulation. Lastly, the comparison of legal obligations arising out of the two regulatory regimes to the distributors of insurance is made.

Regarding methodology, I want to go beyond the descriptive and analytical approach and try to empirically<sup>3</sup> quantify not only the impact of the regulation but also, inseparably, the market players affected. To give an example, for the former, when I discuss the restriction of the tax benefits on life insurance<sup>4</sup>, I point the reader to the highest percentage fall in the last 5 years of the endowment insurance segment where the restriction manifested itself the most. For the latter, I estimate for the first time<sup>5</sup> the real number of distributors of insurance, who are registered intermediaries under Intermediaries Act and are active. Without that, one would not even know how many people are going to be affected by the new regulation, which is striking to say the least.

I have relied on both the domestic and foreign sources to achieve the aims of this thesis. The former includes primarily but not exhaustively: acts; decrees; explanatory memorandums; academic literature; the Czech National Bank's official information, register of insurance intermediaries, ARAD database, reports; the Czech Insurance Association's database, reports and its newsletters *Pojistný obzor* and *Pojistné rozpravy*; annual reports of the insurance undertakings and other market players; all the major web

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<sup>3</sup> See EPSTEIN, Lee; MARTIN, Andrew D. *An introduction to Empirical Legal Research*. Oxford University Press, 2010. 352 p. ISBN 9780199669066

<sup>4</sup> The Act No. 267/2014 Coll., the Act amending the Act No. 586/1992 Coll., on Income Taxes, as amended, and further related acts, restricted the tax benefits of the life insurance as of 1/1/2015. It led to the early termination of policies in, predominantly, endowment insurance segment.

<sup>5</sup> At least from what is publicly available.

outlets or printed newspapers dedicated to insurance (e.g. opojisteni.cz, Ekonom, Euro, etc.). The latter includes inter alia: EU legislation; academic literature; Insurance Europe's reports and databases; European Insurance and Occupational Pensions Authority reports.

The body of the thesis conventionally consists of three chapters. The first one, The Insurance Market, acquaints the reader with the key insurance metric – gross written premium – and provides a segmentation of insurance into product lines. The second one, Distribution Channels, proposes a distribution channels framework that illuminates the way in which insurance undertakings get their products to customers. The third chapter, Regulatory Framework, is the heart of the thesis where I analyze the distribution channels in light of the applicable Intermediaries Act and forthcoming Insurance Distribution Act.

## **1 The Insurance Market**

In this chapter, the reader will get acquainted with the necessary methodology and resources that facilitate an educated modelling of the Czech insurance market. The logic behind the inclusion of this chapter is straightforward: before we can understand distribution, we have to understand the pool it is being distributed from. Otherwise, without this insight, one is condemned to ignorance, both in the qualitative and quantitative sense, when discussing distribution channels. As this chapter is only of a preparatory nature, its storyline is deliberately confined to the core principles that need to be communicated.

At first, I will deal with the concept of a gross written premium as it gives the quantitative sense to the premiums paid for the insurance products that are distributed by intermediaries. Thereby, I will be able to quantify the different segments of insurance products which are, in turn, qualitatively relevant for the regulation and day-to-day business of intermediaries themselves. Lastly, I will briefly outline the market of insurance undertakings as it will be an important reference point during the discussion of distribution channels and intermediaries as such in the following chapters.

### **1.1 Gross Written Premium and Related Sources**

The gross written premium (hereinafter „GWP“) of an insurance undertaking is a sum of premiums paid by policyholders as a consideration for their policies. Thus, GWP of the insurance undertaking is a multiple of the number of policies, in its insurance portfolio, and the average premium. The particular amount of a premium paid by a customer differs considerably and it reflects, inter alia, the following: expected claim amount, probability of the loss event, expenses, profit and safety margin. The basic equation of a premium is then:  $(\text{expected claim amount} \times \text{probability}) + \text{expenses} + \text{profit} + \text{safety margin} = \text{premium}$ <sup>6</sup>. The assessment of a prospective policyholder and the subsequent computation of their premium is called underwriting. Process of underwriting is very complex and it falls outside of the ambit of this thesis and it will not be elaborated further at this point.

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<sup>6</sup> See Insuranceeurope.eu [online]. 2012 [cit. 2018-02-17]. How Insurance Works. Available at WWW: <<https://www.insuranceeurope.eu/sites/default/files/attachments/How%20insurance%20works.pdf>>.

Prima facie, it appears that in order to calculate the size of the insurance market as a whole, one has to sum up the GWP reported by the insurance undertakings in their financial statements (for given accounting periods, i.e. yearly). For that end, the metric has to be anchored in time – something not entirely unambiguous in the insurance industry. According to Czech law, though it is not country-specific, the GWP „*consists of all the amounts, stemming from the policies, payable during an accounting period, notwithstanding the fact that these amounts may pertain, in whole or in part, to a subsequent account period*“<sup>7</sup> [my bold].

Also, it is worth to dispel the layman’s misconception that the GWP equals to the insurance undertakings’ revenues. While GWP is the main source of revenue, the income that flows from investment is relevant as well (and crucial for the overall profitability). To put that into perspective, according to the aggregated data by the Czech Insurance Association (hereinafter „**CAP**“), in life insurance in 2016 the GWP was CZK ~57 bln. and investment income amounted to CZK ~17 bln.

It has been established that GWP is the key metric for understanding the size of the insurance market. However, before I proceed one level below in granularity, i.e. summing up the reported GWP by the insurance undertakings and the necessary methodological adjustments that pertain to it, it is essential to explore where the information about the GWP can be procured. While there are many sources of data, either primary sources<sup>8</sup> or secondary sources<sup>9</sup>, I wish to discuss only two of them: the Czech National Bank (hereinafter „**CNB**“ ) and already mentioned CAP. They are the most relevant one and I will use them throughout this thesis

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<sup>7</sup> Per Article 19, subsection 1 of the Decree No. 502/2002, implementing certain provisions of Act No. 563/1991 Coll., on accounting, as amended, for accounting units that are insurance undertakings, as amended.

<sup>8</sup> That is data stem directly from the insurance undertakings – e.g. the Czech National Bank, CAP or annual reports (henceforth “**AR**”) which the insurance undertakings are obliged to produce under the Act No. 563/1991 Coll., on accounting, as amended.

<sup>9</sup> Those are mostly market intelligence agencies that only package the primary sources of data – e.g. AXCO, Insurance Europe, SNL Insurance, etc.

CNB, embedded in the Constitution of the Czech Republic<sup>10</sup>, is the Czech central bank entrusted with the financial market supervision and resolution authority<sup>11</sup>. The insurance undertakings are obliged to report to CNB under the Decree No. 305/2016 Coll., on reporting by insurance undertakings and reinsurance undertakings to CNB<sup>12</sup>, their, inter alia, GWP for life and non-life insurance. CNB aggregates the inputs provided by all the market players and makes it accessible via the public public database called ARAD<sup>13</sup>.

Unfortunately, in ARAD, there is a data break as of 30/9/2016 due to the change in reporting standards introduced by Solvency II<sup>14</sup>. The pre-Solvency II reporting format, which was discontinued, is manifested by „*Basic information on life/non-life...*“, while the new format reads as „*Selected indicators of life/non-life...*“. As explained in methodology sheet produced by CNB<sup>15</sup>, the former breakdown (i.e. how the GWP is segmented; segmentation will be discussed separately in the following chapter) is in accordance with Annex 1 of the Act No. 277/2009 Coll., on Insurance, as amended (hereinafter „**Insurance Act**“), while the latter is in pursuant to Article 80<sup>16</sup> of Solvency II. The methodology sheet further explains that the latter format „*should reflect the nature of the risks of the underlying policy rather than its legal form*“, in other words a push for harmonisation within the EU.

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<sup>10</sup> Chapter Six, Article 98 of the Act No. 1/1993 Coll., The Constitution of the Czech Republic, as amended

<sup>11</sup> Pursuant to Article 1, Subsection 1, of the Act No. 6/1993 Coll., on the Czech National Bank, as amended

<sup>12</sup> The decree superseded Decree No. 433/2009 Coll., on reporting of insurance and reinsurance undertakings as of 23/9/2016 as a result of the implementation of Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance („**Solvency II**“).

<sup>13</sup> Note, that this data series system is relevant to the whole financial sector and is not limited to insurance, also there is a strong push on behalf of CNB in recent years to aggregate all the data, that were previously presented in separate reports, in ARAD.

For insurance statistics see Cnb.cz for [online]. 2018 [cit. 2018-02-17]. Arad Database. Available at WWW: <<https://www.cnb.cz/docs/ARADY/HTML/index.htm>>

There go to Data selection tab, then Basic indicators of the financial market and then Insurance undertakings.

<sup>14</sup> Delegated Regulation (EU) 2015/35, supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)

<sup>15</sup> See Cnb.cz [online]. 2018 [cit. 2018-02-17]. Arad Database. Available at WWW:

<[https://www.cnb.cz/cnb/STAT.ARADY\\_PKG.PARAMETRY\\_SESTAVY?p\\_strid=BCF&p\\_sestuid=50032&p\\_tab=2&p\\_lang=EN](https://www.cnb.cz/cnb/STAT.ARADY_PKG.PARAMETRY_SESTAVY?p_strid=BCF&p_sestuid=50032&p_tab=2&p_lang=EN)>.

<sup>16</sup> As defined in Annex I to the Commission Delegated Regulation (EU) 2015/35, supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), p. 227-229.

Without getting into more detail, it is submitted that despite the fact that CNB is the most official source of data, ARAD will not be utilized for ascertaining the GWP for two main reasons. Firstly, the data break due to Solvency II entails falling into a rabbit hole if one wants to calculate a longer time series<sup>17</sup> (which I consider desirable). Secondly, CNB aggregated dataset, by definition, does not give data for the individual insurance undertakings, which precludes any market analysis. However, I will use CNB extensively as a data source for other metrics such as the numbers of insurance intermediaries and others.

CAP is a voluntary professional association<sup>18</sup> of insurance undertakings operating on the Czech market. As of 9/2017<sup>19</sup>, twenty-five insurance undertakings were regular members and two had special status - The Czech Undertakings' Bureau<sup>20</sup> and The Export Insurance Company<sup>21</sup>. The latter category of members fall outside of the ambit of our enquiry as they do not underwrite any insurance that would be distributed by intermediaries. The former category represents ~97% of the GWP on the Czech insurance market<sup>22</sup>, thus it will be treated as the whole market. Further, when I refer to CAP data, I mean the dataset known as Individual members' results.<sup>23</sup>

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<sup>17</sup> In order to give the reader some transparency over the presented data, it would deplete too many pages in this thesis and it is not worth it.

<sup>18</sup> CAP's legal form is an association of legal entities established under the previous Civil Code (Act No. 40/1964 Coll., the Civil Code, as amended). Even though the Act No. 89/2012 Coll., the Civil Code, as amended (hereinafter „**New Civil Code**“) does not permit the incorporation of this legal form, those, who had been in existence prior to 1/1/2014 when the new Civil Code came into force, are still valid. Such is the case of CAP which was founded in 1994.

<sup>19</sup> See Cap.cz [online]. 2018 [cit. 2018-02-17]. CAP's individual members. Available at WWW: <<http://www.cap.cz/o-nas/clenove/clenske-pojistovny?limitstart=0>>.

<sup>20</sup> The Czech Undertakings' Bureau is a legal entity established under the Act No. 168/1999 Coll., on liability insurance for damage caused by operation of vehicle, as amended. Per Article 2, letter i), of the Act, it is a professional organization of insurance undertakings, that are allowed to offer liability insurance for damage caused by operating a vehicle (i.e. Mandatory Third Party Liability, hereinafter „**MTPL**“).

<sup>21</sup> The Export Insurance Company is a legal entity established under the Act No. 58/1995 Coll., on Insurance and Financing of exports with State Support and on Supplement to Act No. 166/1993 Coll., on the Supreme Audit Office, as amended. According to the Act, while fully owned by the Czech state, its purpose is to provide export credit risk insurance and thus facilitate the Czech export.

<sup>22</sup> Per 2016 CAP's annual report, which is the latest available data. The average market share of CAP's members for 2010 – 2016 period is also ~97%. That is relevant for longer time series produced later on in the thesis.

<sup>23</sup> See Cap.cz [online]. 2018 [cit. 2018-02-17]. Individual members' results. Available at WWW: <<http://www.cap.cz/statisticke-udaje/individualni-vysledky-clenu>>.

As it was said, the members provide the data to CAP on a voluntary basis. The level of data granularity is higher than CNB has on offer. It does full justice to the product lines delineated in Annex 1 of the Insurance Act and it introduces new segmentation such as business insurance. More importantly, it gives an accurate account of the the base volume of GWP that is distributed to the customers by employing several methodological instruments, unlike CNB that follows the Czech accounting standards.

CAP brokeaway from CNB reporting format in 2011 when it recalculated *single premiums in life on the basis of 10 years (i.e. only one tenth of premiums written is included)*<sup>24</sup>. Thereby, the overall size of the market suddenly “dropped” by ~30% year-to-year. In absolute terms, GWP of the members for 2010 amounted to CZK 153 bln., after the adjustment the year 2010 shrinks to CZK 117 bln. The rationale behind this annualization of single paid life insurance stems from the need to reconcile the business differences between single premium policies and regular paid policies. Per Article 2783, Section 2, of the New Civil Code, in the case of the former the premium is collected upfront, while in the latter case, premiums are collected regularly (monthly, yearly, etc.). The measure technique which overcomes the difference is called annual premium equivalent (hereinafter “**APE**”)<sup>25</sup>. APE is calculated as the sum of regular paid GWP in the given year and 10% of single paid GWP. The calculation is based on the assumption that the average lifespan of an life insurance policy is 10 years and thus the single lump-sum paid the policyholder is spread over the whole period.

On year later, in 2012, CAP introduced the second enhancement, though not so substantial, to its methodology. This time with respect to non-life insurance when it subtracted from the total premiums the premiums ceded to other CAP members. It precludes doublecounting of the GWP and thus approximates us to the actual cake that is subject to distribution to the customers.

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<sup>24</sup> See page 62 of the 2015 CAP AR. All later references to methodology are based on this source. Older ARs shows the historical development of the methodology.

<sup>25</sup> See Investopedia.com [online]. 2018 [cit. 2018-02-17]. Annual Premium Equivalent. Available at WWW: <<http://www.investopedia.com/terms/a/annualpremiumentbasis.asp>>.

In 2014, two major methodological adjustments took place. GWP no longer include cross-border services through a branch or under the freedom to provide services<sup>26</sup>. That means that prior to this adjustment, the Czech insurance market was reported as bigger than the reality would justify. The numerical discrepancy is primarily (~90% in 2011 and 2012) driven by operations of AXA insurance company in Slovakia, which GWP were included in the overall GWP of the Czech insurance market. Secondly, as of 2014, ex lege workers' compensation<sup>27</sup> is not included anymore. That is entirely legitimate as this type of insurance is mandatory under law, it is not part of a business insurance and no distribution is pertinent to it. Due to its historical provenance there are only two providers of this insurance in the Czech Republic: employees who had contracted the insurance with Ceska pojistovna as of 31/12/1992 are insured with this undertaking, the others are insured with Kooperativa pojistovna.<sup>28</sup> In 2006, the Act No. 266/2006 Coll., on Accident Insurance for Employees was passed, which purpose was to rectify the current nonmarket arrangement by moving the mandatory employees insurance to the Czech Social Security Administration. However, it never came into effect and was eventually repealed. According to the draft law of the Ministry of Labour and Social Affairs, the new system under the umbrella of the Czech Social Security Administration could come into force in 2020<sup>29</sup>.

Even though the methodological adjustments discussed above took place in different years it is possible to recalculate the figures in excel and produce an uninterrupted time series. That is from the figures prior to the respective methodological adjustment one can deduct the GWP stemming from the 9/10 of single paid insurance; from AXA Slovakia<sup>30</sup>; from mandatory workers' compensation; from cross-border services through a branch or under the freedom to provide services.

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<sup>26</sup> On the legal basis of The Right of Establishment and The Freedom to Provide Services as outlined in Treaty on The Functioning of the European Union

<sup>27</sup> Pursuant to the Decree 125/1993 Coll., stipulating conditions and rates for ex lege workmen's compensation insurance, as amended, and Articles 265 – 268 of the Act No. 262/2006 Coll., Labour Code, as amended.

<sup>28</sup> Per Article 1, subsection 1, of the Decree 125/1993 Coll., stipulating conditions and rates for ex lege workmen's compensation

<sup>29</sup> See Epravo [online]. 2018 [cit. 2018-02-17]. Summary of important legislation. Available at WWW: <<https://www.epravo.cz/top/clanky/souhrn-vyznamnych-legislativnich-udalosti-662016-1262016-101807.html?mail>>

<sup>30</sup> Available at Slovak Insurance Association. See Slaspo.sk [online]. 2018 [cit. 2018-02-17]. Slovak Insurance Association. Available at WWW: <<https://www.slaspo.sk/18541>>.

It is submitted that CAP has been identified as the most suitable source of data as it gives the highest granularity, transparency over data and most importantly, it gives the accurate picture of a market that is subject to distribution. Therefore, it will be utilized if not stated otherwise.

## 1.2 Segmentation of Insurance

In the previous chapter GWP was established as the most accurate metric for understanding the size of the insurance market and CAP as the most appropriate data source, it is time to explore the different segments of the insurance industry.

Czech law offers multiple classifications of insurance products that stem from various rationals; whether its conclusion is mandatory or contractual (the latter further, perplexingly, divides into voluntary and obligatory insurance); whether the benefit paid by the insurance undertaking is ex ante stipulated or is contingent on the insured event (capital assurance vs loss assurance); whether the insured event pertains to human life (life insurance vs non-life insurance); whether the object of the insurance contract is related to a person, a property or a liability<sup>31</sup>; by product lines that the insurance undertakings offer and many others.

The Czech legal theory draws the distinction between the mandatory and contractual insurance<sup>32</sup>. The mandatory consists only of the mandatory workmen's compensation insurance<sup>33</sup>, with the GWP of CZK 6,7 bln. in 2015. The key differentiator is embedded in the Article 1, subsection 3, of the Decree 125/1993 Coll., stipulating conditions and rates for ex lege workmen's compensation insurance, as amended. It implies that mandatory insurance comes into existence on the date of the conclusion of the employment contract, irrespective of the will of the parties and without concluding an insurance contract.

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<sup>31</sup> Abstracted from Article 2766 of the New Civil Code.

<sup>32</sup> KARFÍKOVÁ, Marie; PŘIKRYL, Vladimír; VYBÍRAL, Roman a kolektiv. *Pojišťovací právo – 2. přepracované vydání*. Praha: Leges, 2018. 440 p. ISBN 9788075022714. Chapter 1.3 Forms and types of insurance.

<sup>33</sup> See the previous chapter 1.1 for further detail.

The contractual insurance is segmented into voluntary and obligatory contractual insurance. In the case of the former, the prospective policy holder has a contractual freedom in relation both to the conclusion of a policy and the person of an insurance undertaking. It is the most common type of insurance both in terms of the number of contracts and their volume: e.g. CASCO, accident insurance or sickness insurance. The latter has aspects of both the mandatory insurance and voluntary contractual insurance in that respect that the prospective policy holder is legally obliged to have his activities covered by an insurance policy, however, they are free to contract with an insurance undertaking of their choice<sup>34</sup>. The rationale is pronounced: in the course of some human activities there is an increased risk or the impending loss is large. As of 2/2018 there are more than 50<sup>35</sup> types of obligatory contractual insurance, e.g. Mandatory Third Party Liability per Act No. 168/1999 Coll., on liability insurance for damage caused by operation of vehicle, as amended, or solicitor's liability insurance per Article 24a of the Act No. 85/1996 Coll., on Advocacy, as amended.

The New Civil Code distinguishes between Capital Assurance (also Fixed-Amount Insurance) and Loss Insurance. The Article 2821 reads as follows: "*Fixed-amount insurance undertakes the undertaking to provide, in case of an insured event, a lump-sum or repeated insurance indemnity in the stipulated amount*"<sup>36</sup>. The ax ante stipulated insured amount (i.e. the capital) is the differentiating factor. The most common type (in terms of GWP volume) is insurance on survival, death or survival/death.

Loss insurance is, indirectly<sup>37</sup>, defined in the Article 2811 of the Civil Code, which explains that: „*In the case of insurance against loss and damage, the undertaking shall provide insurance indemnity which shall, to the stipulated extent, compensate for the loss*

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<sup>34</sup> See Article 132a of the Insurance Act.

<sup>35</sup> See Cap.cz com [online]. 2018 [cit. 2018-02-17]. Insurance products by types. Available at WWW: <<http://www.cap.cz/pojistne-produkty/podle-druhu-produktu>>.

<sup>36</sup> The citation is taken from the wording of translation provided by the Czech Bar Association. See Cak.cz [online]. 2018 [cit. 2018-02-17]. English translation of the Czech Civil Code. Available at WWW: <<https://www.cak.cz/scripts/detail.php?id=14224&tmplid=15>>.

<sup>37</sup> The direct definition is in the repealed Article 3, letter z) of the Act 37/2004 Coll., on Insurance Contract and on Amendments to Related Acts.

*of property incurred as a result of an insured event*<sup>38</sup>. Thus, in this case, only the extent and calculation method is part of the insurance contract and the insured amount, contingent on the insured event, cannot be ax ante discerned.

When one does the segmentation of any kind, and not merely drafting common denominators of different pieces of information at hand, it is imperative to adhere to the so called *MECE* principal that stands for mutually exclusive and collectively exhaustive<sup>39</sup>, i.e. the sum of the segments equals total and there is no overlap. Further, we have to be able to quantify the segments (otherwise we would not be able to see whether it is MECE) and most importantly, in our case, it has to yield the greatest insight into the structure of the market from the business perspective.

In order to accommodate the laid out conditions, we are left, essentially, with the segmentation on life insurance, which is mainly bought for covering the risk of death and long-term savings, and non-life insurance that is mainly bought for protection and not as an investment.<sup>40</sup> The breakdown of the two is the primary concern of this chapter and is outlined in subchapters 1.2.1 and 1.2.2.

### **1.2.1 Life Insurance: Breakdown and Quantification**

Pursuant to Article 2824, Section 1 and Article 2833 of the New Civil Code, the life insurance is a personal insurance stipulated as fixed-amount insurance<sup>41</sup> with exhaustive list of risks that can be insured – in plain words those are death, reaching a certain age

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<sup>38</sup> See note 32.

<sup>39</sup> Though this is not always possible to realize unconditionally, notice that I acknowledge and try to quantify all the exceptions that violate the rule.

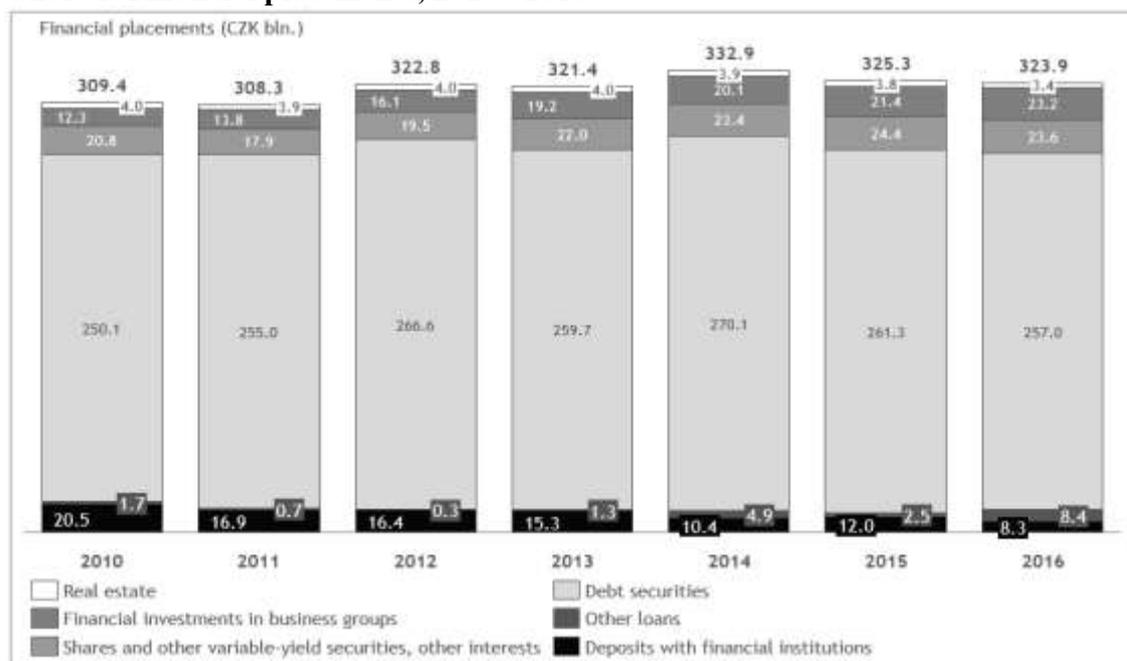
<sup>40</sup> As a side note, theoretically the most common split is on life insurance, non-life insurance, health insurance and reinsurance. However, health insurance (related to the health of an individual) falls to either of the two previous categories depending on the jurisdiction. In the Czech Republic, as it will be explored later on in greater detail, the health falls into non-life insurance where it takes form of accident insurance and sickness insurance, nevertheless, if it is a supplementary insurance to a life insurance product, then it falls to life insurance segment (e.g. the UK has the same arrangement, it is not unusual). Therefore, it is dissolved in both of the segment. The same is the case with reinsurance. reinsurance is defined in Article 3, letter l) of the Insurance Act and in plain words it is an insurance for a primary undertaking provided by a reundertaking<sup>40</sup> who assumes an insurance risk in exchange for a premium. In the Czech Republic, there is only one home reinsurance company – VIG RE zajistovna, a.s.

<sup>41</sup> For fixed-amount insurance refer to chapter 1.2.

(survival) and deterioration of health either as a result of an accident or a sickness.<sup>42</sup> Though the insurable risks are straightforward, the second listed risk explicitly opens the doors to another layer of the life insurance – not only it covers risks, it can additionally act as a saving and an investment instrument.

In chapter 1.1. dedicated to GWP, it has been established that the premium is calculated as (expected claim amount x probability) + expenses + profit + safety margin. However, that is only the case of an insurance that covers risks only, when the policy holder wants the insurance product to serve also as a saving or an investment we need to add that into our equation. Thereby, a capital is accumulated and it is utilized by the insurance undertaking as the financial placements.

**Chart 1. Financial placements, 2010 - 2016**



These are understood as a disposal of an insurance undertaking's assets<sup>43</sup> reflected by technical provisions in the balance sheet (as passives). The insurance undertaking creates technical reserves to match liabilities, stemming from its insurance business, that are

<sup>42</sup> Article 2824, Section 1 of the New Civil Code expresses it more eloquently as: "... death, .. reaching a certain age or date contractually agreed as the end of insurance, against sickness, accident or another fact related to health or change of personal status of the person insured."

<sup>43</sup> Per Article 3, Section 1, letter m) of the Insurance Act.

likely or certain to be incurred, but uncertain as to their amount or as to the date on which they will arise.<sup>44</sup>

In light of the following, we can distinguish life insurance policies as to whether the capital is accumulated (i.e. insurance with or without the saving or investment component) and, correspondingly, as to whether it creates technical reserves or not. Along these criteria, there is 1) term life insurance; 2) endowment life insurance (and its subset pension insurance); 3) unit-linked insurance (also called investment insurance).

Two points are left to be explored: tax advantage and guaranteed technical interest rate. The former stands for the possibility, subject to conditions, to deduct the paid premium from the compulsory taxes<sup>45</sup> in the case of endowment life insurance and unit-linked insurance. The latter refers to the case of endowment life insurance, where the policy holder has a guaranteed *return on investment*, unlike in the case of unit-linked insurance, where the policy holder bears the investment risk<sup>46</sup>.

**Table 1. Comparison of Life Insurance**

Type	Insured Risk			Accumulation of Capital	Tax Advantage	Creates Reserves	Guaranteed Savings	Investment
	Death	Survival	Supplement.					
Term LI	yes	no	yes	no	no	no	no	no
Endowment LI	yes	yes	yes	yes	yes	yes	yes	no
Unit-Linked LI	yes	yes	yes	yes	yes	yes	no	yes

I am aware that the preceding content-heavy part was delivered at a rapid pace, thus I have drawn a summary table. The firm internalization of these concepts is particularly relevant for the distribution phase that I cover in the following chapters and also for the understanding of the growth and decline in different segments of life insurance that will be covered shortly.

<sup>44</sup> Per Article 52, Section 1, of the Insurance Act.

<sup>45</sup> Per Article 15, Subsection 6 of the Act No. 586/1992 Coll. of the Czech National Council, on Income Taxes, as amended (henceforth “**Act on Income Taxes**”), the natural persons can deduct up to CZK 24 ths (as of 1/1/2017) from their taxes and per Article 6, Subsection 9, letter p) of the Act on Taxes, the employer who contributes to an employee’s life insurance can, subject to conditions, deduct the contributions of up to CZK 50 ths (as of 1/1/2015) made from their compulsory taxes.

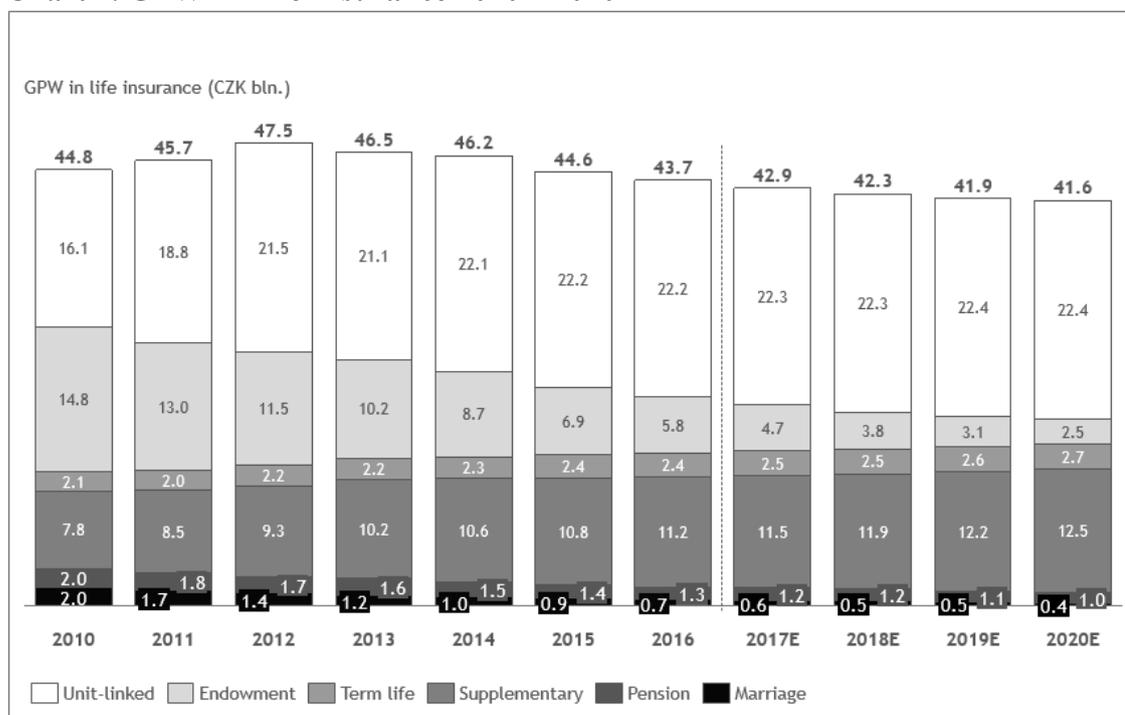
<sup>46</sup> Prior to 1/1/2016, the CNB determined the guaranteed technical interest rate via its official notice – last time it was 1,3% in line with the repealed Decree No. 434/2009 Coll. on Implementing Certain Provisions of the Insurance Act. At the moment it is up to an undertaking to stipulate the guaranteed technical interest rate (e.g. Ceska pojistovna AR 2016 says that it ranged from 1,3% to 6% in life insurance).

Annex 1, Part A of the Insurance Act delineates the life insurance product lines into 9 categories. The categories look confusing but if we follow CNB segmentation, which is also observed (with some alterations) by CAP, it is possible to simplify it, without losing or double counting any GWP (thus MECE), into 6 segments:

1. Unit-linked insurance
2. Insurance against accident or sickness as a supplement to life insurance (henceforth „**Supplementary Insurance**“)
3. Endowment life insurance
4. Term life insurance
5. Pension Insurance
6. Marriage insurance, birth insurance (henceforth „**Marriage Insurance**“)

Then, utilizing CAP data and doing the necessary calculations in excel we can visualize the data into the following graph:

**Chart 2. GPW in Life Insurance 2010 – 2020<sup>47</sup>**



<sup>47</sup> The 2017 - 2020 prediction is based on the 2014 – 2016 CAGR of each segment (simple extrapolation).

At this point, I think that it is fair to say, that the graph has to strike both the laymen and an educated reader. The bottom line clearly is that the market is stagnating despite the fact that all macroeconomic indicators which are intertwined with life insurance are pointing otherwise – such as GDP growth, low unemployment and growing households disposable income. Also, the Czech life insurance market is notoriously under-insured in relation to other EU member states – in 2016, the Czech GWP to GDP equaled 1,3%<sup>48</sup>, while the EU28 weighted average amounted to 4,5%<sup>49</sup> - which precludes us from the conclusion that the market is saturated and there is no room for growth.

I will elaborate on the reasons for the stagnating market and shifts in segments. Firstly, the amendment<sup>50</sup>, effective as of 1/1/2015, of the Act on Income Taxes restricted the tax benefits of the life insurance. It stipulated that the premium paid into the policies that enabled exceptional withdrawals would not qualify as tax deductible. It led to the early termination of policies in, predominantly, endowment insurance segment (that included the saving component) which witnessed the highest percentage fall in the last 5 years.

Another trend, that impacted endowment insurance the most, were the low interest rates, that were effective since the world financial crisis<sup>51</sup>, and the ensuing decreasing guaranteed technical interest rates<sup>52</sup>. In the preceding *Chart 1. Financial placements*, it can be observed that the insurance undertakings invested heavily into state's bonds<sup>53</sup> which in the context of low interest rates could yield only very low returns on investment. Thereby, the endowment and unit-linked insurance lost competitiveness to other investment opportunities such as asset management that has experienced unprecedented growth in the past 5 years.

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<sup>48</sup> GWP data taken from CNB (not annualized premiums), GDP data taken from the Czech Statistical Office, own calculation.

<sup>49</sup> Per statistics released by Insurance Europe. See Insuranceeurope.eu [online]. 2018 [cit. 2018-02-17]. Statistical Database. Available at WWW: <<https://www.insuranceeurope.eu/insurancedata>>.

<sup>50</sup> The Act No. 267/2014 Coll., the Act amending the Act No. 586/1992 Coll., on Income Taxes, as amended, and further related acts.

<sup>51</sup> The interest rates were raised by CNB in August 2017 for the first time since 2008.

<sup>52</sup> See note 46.

<sup>53</sup> The reason behind the majority share of state's bonds is that the share of risk assets is stipulated by law to ensure the solvency of the insurance undertaking and thereby protect the consumer's interest.

Thirdly, the market failure<sup>54</sup> between insurance intermediaries and insurance undertakings that had existed prior to the amendment<sup>55</sup> of the Act 38/2004 Coll., Act on Insurance Intermediaries and on Independent Loss Adjusters and on Amendment to the Trades Licensing Act, as amended (henceforth “**Intermediaries Act**” or “**IA**”), in 1/12/2016. An intermediary received a commission, from the insurance undertaking for each concluded policy, which was substantial in the life insurance segment where it ranged (on average) from 160% to 180% of the annual GWP<sup>56</sup>. Then, after receiving the commission in a lump sum, the intermediary had revised the policy and, thereby, received the commission again. That resulted in the situation when insurance undertakings had been paying high commissions to the intermediaries while the life insurance penetration had declined. The aforementioned amendment of the Intermediaries Act addressed the issue when it stipulated that the commissions will be spread out into the five-year period and in the case of an earlier termination of a policy, the intermediary will have the right to only proportional part of the commission.<sup>57</sup>

Lastly, the new trend, that can be observed, is the growth of term life insurance.<sup>58</sup> This customer preference shift to pure risk insurance reflects the general distrust towards the insurance with investment or saving component; which has been triggered by the market failure between intermediaries and undertakings and general negative media coverage of the intermediaries practices.

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<sup>54</sup> DAŇHEL, Jaroslav; DUCHÁČKOVÁ, Eva. Český pojistný trh se (ne)vrací na cestu efektivnosti. *Pojistné rozpravy 33: pojistně teoretický bulletin*. 2017. Volume 33, ISSN 08626162. p. 30-34.

<sup>55</sup> The Act No. 295/2016 Coll., the Act amending the Act 38/2004 Coll., Act on Insurance Intermediaries and on Independent Loss Adjusters and on Amendment to the Trades Licensing Act, as amended.

<sup>56</sup> See Deloitte.com [online]. 2018 [cit. 2018-02-17]. Market research conducted by Deloitte and STEM/MARK. Available at WWW: <<https://www2.deloitte.com/cz/cs/pages/about-deloitte/articles/cze-kvalita-prodeje-zivotniho-pojisteni.html>>.

<sup>57</sup> See Article 21e of the Intermediaries Act.

<sup>58</sup> Inferred from the data and statements by insurance undertaking’s CEOs, for example, see Opojisteni.cz [online]. 2018 [cit. 2018-02-17]. Insurance industry in 2015. Available at WWW: <<http://www.opojisteni.cz/tema/pojistovnictvi-v-roce-2015-cpp/>>.

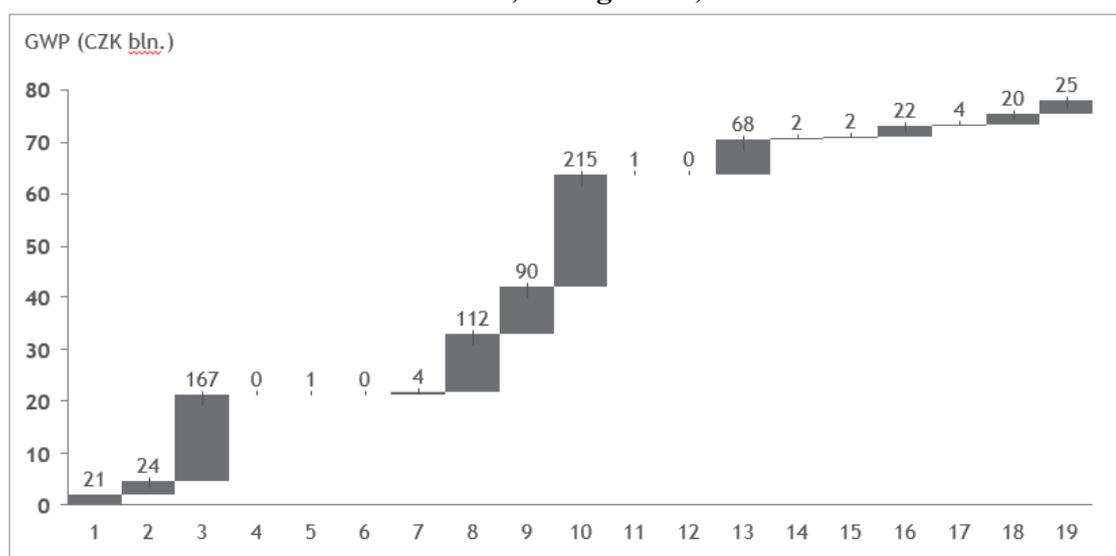
### 1.2.2 Non-Life Insurance: Breakdown and Quantification

The simplified classes of non-life insurance are per Annex 1, Part B of the Insurance Act as follows:

- |   |   |
|---|---|
| 1. Accident insurance   | 10. Motor Third Party Liability <sup>59</sup> (henceforth „MTPL“) and other liability insurance                                     |
| 2. Sickness insurance   |   |
| 3. Motor hull insurance except rolling stock (henceforth „CASCO“)   | 11. Aircraft liability insurance  |
| 4. Rail damage insurance  | 12. Marine liability insurance  |
| 5. Aircraft hull insurance  | 13. General liability insurance against damage not covered under classes 10 to 12   |
| 6. River and sea hull insurance   | 14. Credit insurance  |
| 7. Transport freight insurance  | 15. Suretyship insurance (guarantee deposits)   |
| 8. Property insurance not included in classes 3-7; the loss caused by fire, explosion, windstorm and other  | 16. Insurance against various financial losses  |
| 9. Property insurance not included in classes 3-7; the loss caused by hailstorm, freezing, theft, robbery and other reasons not mentioned in cl.8 | 17. Legal expenses insurance  |
|   | 18. Assistance insurance for persons in emergencies during travel or while away from their permanent residence („Travel insurance“) |
|   | 19. Inward insurance  |

Though nineteen different classes of non-life insurance might appear overwhelming, one gets a much clearer picture of the market when the GWP of the respective classes is visualized:

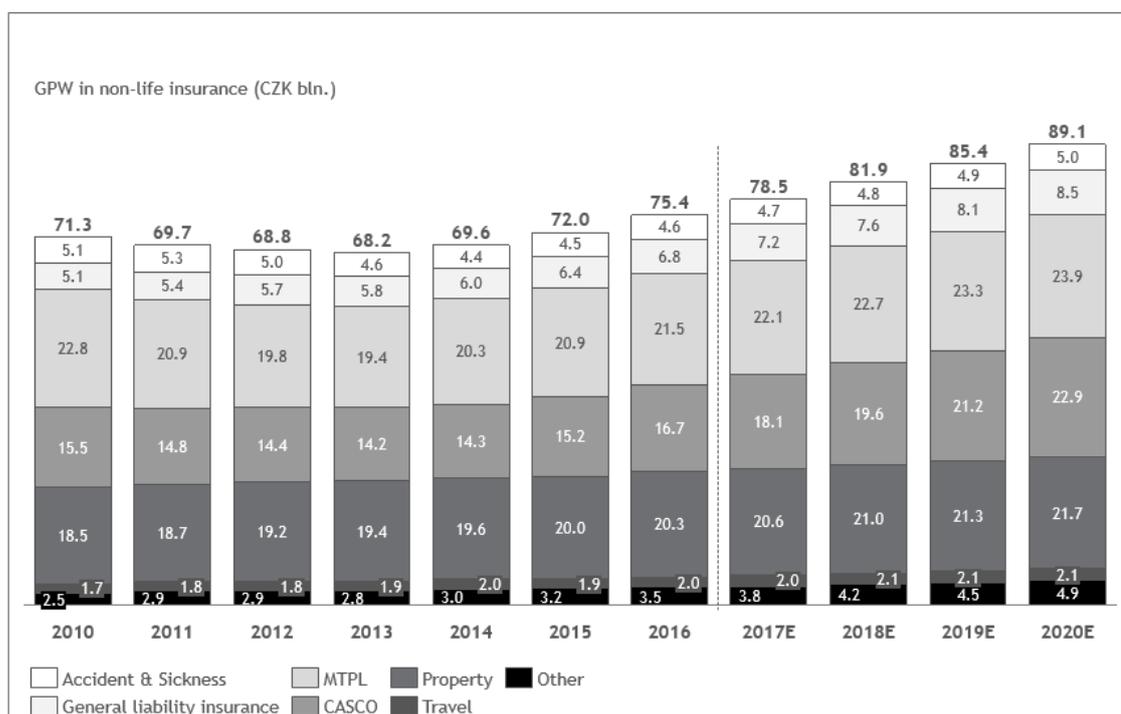
**Chart 3. GWP in Non-Life Insurance, all segments, 2016**



<sup>59</sup> Pursuant to Act No. 168/1999 Coll., on Motor Third Party Liability Insurance, as amended.

It is evident that the non-life insurance market is much less fragmented than anticipated by the number of categories. CASCO, MTPL and property insurance (i.e. sum of class 8 and 9) make up ~80% of all GWP. As in the case of life insurance, using CAP data and doing the necessary calculations in excel, one can visualize the data into the following graph:

**Chart 4. GWP in Non-Life Insurance, segmented, 2010 - 2020<sup>60</sup>**



Non-life insurance segments are more straightforward and less affected by regulatory environment. The market is experiencing a healthy growth and none of the segments is in decline. GWP in CASCO and MTPL segments is a direct result of the multiple of the number of registered cars and their average price and it follows the year-to-year increase in the both metrics. The 2,4% 2014 – 2016 CAGR in Accident & Sickness insurance mirrors the 2,8% 2014 – 2016 CAGR in Supplementary insurance<sup>61</sup>.

<sup>60</sup> The 2017 - 2020 prediction is based on the 2014 – 2016 CAGR (simple extrapolation).

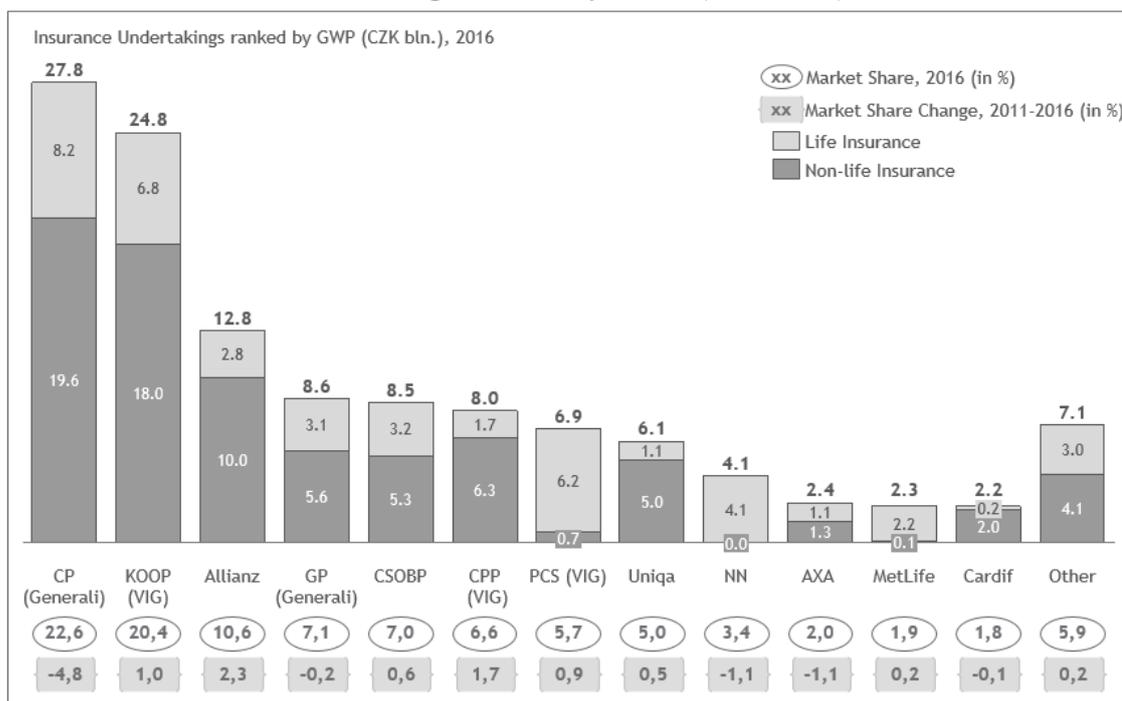
<sup>61</sup> Note, it is the only life insurance segment along with term life insurance that is growing.

### **1.3 Insurance Undertakings**

As of 31/12/2017, there have been 52 insurance undertakings registered with CNB and operating on the Czech insurance market. They are regulated, inter alia, by the Insurance Act which distinguishes between insurance undertakings that provide life insurance and those that provide non-life insurance. The split on life and non-life insurance is within the meaning of previous chapters 1.2.1 and 1.2.2.

However, the restriction not to provide life insurance and non-life insurance as one legal entity had not been in place during the 1990s when the largest insurance groups established themselves on the Czech market. Since the decision to preclude this duality does not have a retroactive effect, there are mixed insurance undertakings even today such is the case of, for instance, Kooperativní pojišťovna, a.s. or Česká pojišťovna, a.s. The insurance groups such as AXA that entered the market later comply with the law by setting up two legal entities, one for life, one for non-life, producing separate annual reports, keeping separate accounts, etc. However, during the day to day business of the insurance undertaking this duality is not visible both from the perspective of a customer and from the perspective of a management. Thus, when calculating the market I will treat them as one company. In chapter 1.1, it was said that CAP has 25 regular members that represent 97% of the total GWP. The market is therefore more way more consolidated than it would have appeared with regards to the number of registered insurance undertakings with the CNB.

**Chart 5. Insurance Undertakings ranked by GWP (CZK bln.), 2016<sup>62</sup>**



From the chart several key observations can be inferred. Firstly, the market is dominated by two foreign insurance groups – VIG and Generali. If one sums up the three insurance undertakings falling under VIG, that is KOOP, CPP and PCS, it yields 32,8% market share. Generali group, with insurance undertakings CP, CP Zdraví and Generali, represents 29,7% of the market.. The two largest groups thus held 62,5% of the market in 2016. Also, there had been interesting gains and losses of the market share between 2011 and 2016 as Generali group lost 5,1% mainly at the expense of VIG and Allianz that gained 3,6% and 2,3% respectively. However, it is not only the case of VIG and Generali group, in fact the whole Czech insurance market is dominated by foreign owned insurance undertakings that fall into larger insurance groups. None of the largest 12 insurance undertakings has a domestic owner.

<sup>62</sup> CP = Česká pojišťovna, a.s. + ČP Zdraví, a.s.; KOOP = Kooperativa, pojišťovna, a.s.; Allianz = Allianz pojišťovna, a.s.; GP = Generali Pojišťovna a.s.; CSOBP = ČSOB Pojišťovna, a. s., člen holdingu ČSOB; CPP = Česká podnikatelská pojišťovna, a.s.; Uniqa = UNIQA pojišťovna, a.s.; NN = NN Životní pojišťovna N.V., pobočka pro Českou republiku; AXA = AXA pojišťovna a.s. + AXA životní pojišťovna a.s.; MetLife = MetLife Europe d.a.c., pobočka pro Českou republiku; Cardif = BNP Paribas Cardif Pojišťovna, a.s.; Other = AEGON Pojišťovna, a.s. + D.A.S. Rechtsschutz AG, pobočka pro ČR + DIRECT pojišťovna, a.s. + ERGO pojišťovna a.s + ERV Evropská pojišťovna, a. s + Hasičská vzájemná pojišťovna, a.s + HDI Versicherung AG, OS + Komerční pojišťovna, a.s. + MAXIMA pojišťovna, a.s. + Pojišťovna VZP, a.s. + Slavia pojišťovna a.s.; VIG = Vienna Insurance Group. For the reader's convenience, I will use only these common abbreviations for the rest of this thesis.

## 2 Distribution Channels

In the previous chapter, I calculated that the policy holders paid CZK ~122 bln. for their policies in 2017. Then, using the legal classes set out by the Insurance Act, I reclassified these premiums paid, while observing the MECE principle, into different product lines such as endowment insurance in life segment or MTPL in non-life segment.

The customers, intermediaries and insurance undertakings themselves all operate within these product lines while doing business.

Establishing the relevant product lines and quantifying them precludes one from drawing unjustified conclusions while discussing distribution channels. To give an example: the sale of insurance online has been discussed extensively lately, particularly in the case of Travel insurance and MTPL insurance, where it accounts for ~30% and ~5% of all sales<sup>63</sup> respectively (in other product lines online sales are negligible or non-existent). However, when confronted with the data in the previous chapter, one calculates that it represents ~2% of total GWP and thus it is much ado about nothing.

It is now time to understand the manner in which the insurance undertakings reach the prospective policy holders and contract the policies with them. This process is called distribution.<sup>64</sup> It consists of multiple distribution channels in order to penetrate as much of the market as possible. The reason why insurance undertakings make use of various distribution channels is twofold: each customer segment and each product line is more apt to a different distribution channel.

The distribution channels are surely not under-theorized in the Czech literature. During a brief research, I have encountered 8<sup>65</sup> various accounts of possible categorization of the

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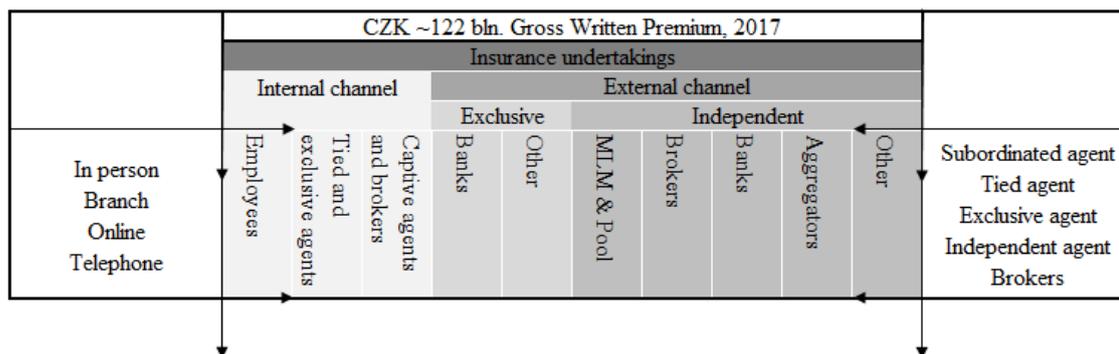
<sup>63</sup> Based on expert interviews with the leading online aggregators such as epojisteni.cz, top-pojisteni.cz, klikpojisteni.cz, etc.

<sup>64</sup> It is important to understand distribution per se within the context of a general insurance value chain which, broken down into the indispensable components, is as follows: 1) product management and marketing; 2) sales and distribution; 3) underwriting and pricing; 4) policy administration; and 5) claims management. For more details see Pwccn.com [online]. 2017 [cit. 2018-02-17]. Available at WWW: <<https://www.pwccn.com/en/industries/financial-services/insurance/the-insurance-value-chain.html>>

<sup>65</sup> HRUBOŠOVÁ, Marcela. *Profese pojišťovací zprostředkovatel, aneb, Co by měl každý "pojišťovák" vědět*. Praha: Linde, 2009. 119 p. ISBN 9788072017751. p. 11-15.  
ZUZAŇÁK, Aleš; ŠULCOVÁ, Jaroslava; HORA, Jan. *Příručka pro zprostředkovatele pojištění*. 2<sup>nd</sup> ed. Praha: Linde, 2011. 249 p. ISBN 9788072018383. p. 44.

distribution channels. While studying them, I realized that the majority of them are fundamentally flawed in three respects. I will use this chapter to explain my line of critique and present my own holistic conception of the distribution channels. Nevertheless, for the sake of clarity and readers' convenience, I outline my idea in a chart here at the outset.

**Table 2. Distribution Channels Framework**



Firstly, the authors mix the manner in which a customer is approached by the person offering the product (e.g. at branch, online, in person) and the characteristics of the offeror (an employee of an insurance undertaking, an employee of a bank, agent, etc.). One cannot say that among distribution channels there is bancassurance<sup>66</sup>, direct marketing through telephone and email, intermediaries, etc. Those are not mutually exclusive categories. The typical customer journey of a prospective policy holder that concludes an insurance policy via the bancassurance channel will typically encompass all the manners of communication mentioned above. At first, a bank representative will call the bank's client and offer him an insurance policy, then he will send him details to his email address. The customer will then check the information at the bank's website and accepts the meeting at a branch. At the branch the policy is concluded, that is called the omnichannel customer experience. Thus, at the chart the methods of communication go horizontally

HRADEC, Milan; KŘIVOHLÁVEK, Václav; ZÁRYBNICKÁ, Jana. *Pojištění a pojišťovnictví*. Praha: Vysoká škola finanční a správní, 2005. 215 p. ISBN 9788086754482. p. 92.

ZUZAŇÁK, Aleš. *Marketing v pojišťovnictví*. Praha: Linde, 1998. 79 p. ISBN 8072011375. p. 53

*Vybrané kapitoly z pojišťovnictví*. 1<sup>st</sup> ed. Praha: Česká asociace pojišťoven, 1996. 176 p. p. 107-111.

ČEJKOVÁ, Viktória, Dana MARTINOVICHOVÁ a Svatopluk NEČAS. *Poistný trh: teória i prax*. 1<sup>st</sup> ed. Bratislava: Iura edition, 2011. 222 p. ISBN 9788080783990 p. 67.

Official Information of the Czech National Bank of 21 January 2014 regarding management and control exercised by the insurance undertaking in relation to its distribution channel.

<sup>66</sup> That is, when an insurance policy is concluded with a representative of a bank while the bank is an agent of an insurance underaking.

through all the distribution channels. While it is true that some of the channels outlined in my chart rely more heavily than others on distinct communication methods (or even absolutely such is the case of aggregators), it nevertheless captures the business case more faithfully.

The second most mistaken approach, that I encountered while reading through various classifications is segmenting the external channel into more than two categories such as exclusive agency, independent agency and others (and then enumerating banks, car dealers, etc). That clearly defies logic, there cannot be anything falling out of the spectrum of independent and exclusive agency. However, I can preliminary inform that, though it is very perplexing, under the current Czech law most of the distributors of insurance are both independent and exclusive agents at the same time. To continue with the example of bancassurance, Československá obchodní banka, a.s. (a bank entity) is in a relationship of exclusive agency with CSOBP, while Česká spořitelna, a.s. (a bank entity) is in an independent relationship with CP and KOOP and PCS. That is illustrated in the *Table 2. Classification of Distribution Channels* where banks and other are represented both as an exclusive agency and an independent agency.

Lastly, and perhaps most importantly for the purpose of this thesis, the authors employ the Czech legal categories of intermediaries (such as *exclusive agent*<sup>67</sup> or *broker*<sup>68</sup>) as types of distribution channels and thus use them along with channels like online or a bank in their segmentation of distribution channels. That is clearly ill-conceived and I will explain why. For instance, the legal category of an *insurance agent*<sup>69</sup> does not create any legal person or a specific human kind walking around the Earth and offering insurance policies. It is not even a category that would define a person exclusively as, for instance, 64%<sup>70</sup> of all persons who act as *insurance agents* also act as different legal categories

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<sup>67</sup> Per Article 6a of the Intermediaries Act. Henceforth, I will put the term into italics when referring to the phrase in the legal sense.

<sup>68</sup> Per Article 8 of the Intermediaries Act.

<sup>69</sup> Per Article 7 of the Intermediaries Act.

<sup>70</sup> I have downloaded all the sheets from the CNB registry as of 7/11/2017 that include all types of registered insurance intermediaries. I compiled the sheets into one excel model and then via functions and pivot tables calculated the actual figures for individual natural or legal persons: ranging from unique numbers, overlap between categories to geoanalytics, etc. I will come back to this dataset in chapter 3.1.3, where I will try to model the real number of active insurance intermediaries operating on the Czech insurance market. The

such as *insurance brokers* (50% of them). Thus, it is a category applicable to multiple of distribution channels and cannot be considered as one. It is visualized (similarly as in the case of methods of communication) horizontally to indicate that the legal categories of intermediaries may appear in several distribution channels.

Ultimately, every insurance undertaking as a legal person has to be represented by a human agent. Thus, the insurance undertaking acts as a principal and an agent conducts business on its behalf, which is called an agency.<sup>71</sup> Therefore, in the strict sense, all the persons involved in distributing the products are agents. The law then gives various degree of rights and obligations to agents, in the broadest sense, who conduct the insurance business on behalf of the insurance undertaking. Thus, the regulatory landscape, as the title of this thesis goes, is an invisible set of rules that pertain to some distribution channels more to some less and to some not at all.

The *Table 2. Classification of Distribution Channels* is outlined from the perspective of an insurance undertaking and on its first level it distinguishes between internal and external channel. The former consists of agents, in the broadest sense, who fall under direct control of the insurance undertaking and whose contract with the insurance undertaking precludes them, practically or contractually, from working for another insurance undertaking.<sup>72</sup> The latter consists of all other agents. I pause the description of my framework here and I will return to it in chapter 3, as I believe that the legal understanding of the intermediaries is a *conditio sine qua non* for discerning the nuances between individual distribution channels.

To summarize, there are general concepts of agency and intermediation and those are not country-specific, they apply everywhere in the insurance industry (though not limited to). Then, there are multiple non-binding frameworks how we can perceive the different distribution channels, I presented mine in the *Table 2. Classification of Distribution*

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source of data can be accessed at Apl.cnb.cz [online]. 2017 [cit. 2017-11-7]. Registry of Intermediaries. Available at WWW: <[https://apl.cnb.cz/apljerrsdad/JERRS.WEB07.INTRO\\_PAGE?p\\_lang=cz](https://apl.cnb.cz/apljerrsdad/JERRS.WEB07.INTRO_PAGE?p_lang=cz)>

<sup>71</sup> LOWRY, John; RAWLINGS, P J; MERKIN, Robert. *Insurance Law: Doctrines and Principles*. 3<sup>rd</sup> edition. Oxford: Hart Publishing, 2011. 618 p. ISBN 9781849462013. p. 59

<sup>72</sup> Despite the fact that Intermediaries Act explicitly allows the given intermediary type to cooperate with multiple insurance undertakings.

*Channels.* And finally, there is law that provides the rights and obligations to the persons involved in the distribution process. The sole task of the chapter 3 is to explore which parts of the distribution channels framework are regulated, explain how and evaluate the effectiveness of the regulation.

### 3 Regulatory Framework

This thesis is written in the period when the Czech legal framework, related to the issues of insurance distribution, is expecting a fundamental change in 2018. At the time of the submission of the thesis, that is 29<sup>th</sup> of March 2018, the main governing law over insurance intermediaries was the Intermediaries Act that I already touched upon in the previous chapters. The anticipated new legislation that would supersede the Intermediaries Act is the current governmental proposal of the Insurance Distribution Act<sup>73</sup>.

Both the Intermediaries Act and the proposed Insurance Distribution Act are driven by the directives of the European Union. The former reacted to the Directive 2002/92/EC of the European Parliament and the Council of 9 December 2002 on insurance mediation<sup>74</sup> (henceforth “**IMD**”) and the latter is an implementation of the Directive (EU) 2016/97 of the European Parliament and the Council of 20 January 2016 on insurance distribution<sup>75</sup> (henceforth “**IDD**”) that supersedes the IMD. Originally, the member states had been bound by IDD to transpose it into national law no later by 23/2/2018. However, this deadline was postponed on 14/2/2018<sup>76</sup> by the Council of the EU when it confirmed the proposal<sup>77</sup>, made on 20/12/2017, of the European Commission to postpone the transposition deadline to 1/7/2018 and the application date to 1/10/2018. The Insurance Distribution Act is in the legislative procedure and I will act on the hypothesis<sup>78</sup> that it will pass into law within the extended time framework.

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<sup>73</sup> For full text see Apps.odok.cz [online]. 2018 [cit. 2018-02-17]. Insurance Distribution Act. Available at WWW: <<https://apps.odok.cz/veklep-detail?pid=KORNAKEFEG4P>>.

<sup>74</sup> See Eur-lex.europa.eu [online]. 2018 [cit. 2018-02-17]. Insurance mediation directive. Available at WWW: <<http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32002L0092>>.

<sup>75</sup> See Eur-lex.europa.eu [online]. 2018 [cit. 2018-02-17]. Insurance distribution directive. Available at WWW: <<http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=OJ:L:2016:026:FULL&from=EN>>.

<sup>76</sup> See Consilium.europa.eu [online]. 2018 [cit. 2018-02-17]. Insurance rules delay approved by Council. Available at WWW: <<http://www.consilium.europa.eu/en/press/press-releases/2018/02/14/insurance-rules-delay-approved-by-council-on-14-february-2018/>>.

<sup>77</sup> See Ec.europa.eu [online]. 2018 [cit. 2018-02-17]. New application date for the insurance directive. Available at WWW: <[https://ec.europa.eu/info/law/insurance-distribution-directive-2016-97-eu/upcoming\\_en](https://ec.europa.eu/info/law/insurance-distribution-directive-2016-97-eu/upcoming_en)>.

<sup>78</sup> On the assumption that the text is nearly final and only minor issues are subject to discussions (such as the regulation of the fleet insurance).

I hold that the amendments made by the new regulation are far from minor and for that reason I have decided to subject the market situation to both scenarios with equal scrutiny. Therefore, I will dedicate one separate subchapter to the current regulation, followed by a subchapter on the anticipated Insurance Distribution Act.

### **3.1 Distribution under Intermediaries Act**

#### **3.1.1 Categorization of Intermediaries and their Differentiating Factors**

In its Article 4, the Intermediaries Act distinguishes six types of insurance intermediaries:

1. tied insurance intermediary (henceforth “*tied agent*” or “*VPZ*”<sup>79</sup>);
2. subordinated insurance intermediary (henceforth “*subordinated agent*” or “*PPZ*”);
3. exclusive agent (henceforth “*exclusive agent*” or “*VPA*”);
4. insurance agent (henceforth “*independent agent*” or “*PA*”);
5. insurance broker (henceforth “*broker*” or “*PM*”);
6. insurance intermediary whose home Member State is not the Czech Republic (henceforth “*foreign intermediary*”)

If one excludes the *foreign intermediary*, as a distinct kind, there are five different types of insurance intermediaries. The terminology and the complexity of this categorization is baffling indeed and many, even prestigious market intelligence companies like Axco<sup>80</sup>, struggle to get their analysis of the Czech market right. This complexity is “multiplied” when one realizes that the given type of an intermediary does not, necessarily, stand for one person as was revealed in the previous chapter 2. Per article 12 of the Intermediaries Act, there is a register<sup>81</sup> administered by CNB, where legal or natural persons need to be registered in order to pursue the business of a given type of intermediation. There is nothing in the law that would preclude one legal or natural person to register as multiple types of intermediaries.

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<sup>79</sup> The abbreviations are used for a more seamless reading experience for a reader who is embedded in the Czech context.

<sup>80</sup> See Axcoinfo.com [online]. 2018 [cit. 2018-02-17]. Axco Market Intelligence. Available at WWW: <<http://www.axcoinfo.com/>>.

<sup>81</sup> See Apl.cnb.cz [online]. 2018 [cit. 2018-02-17]. Register of Intermediaries. Available at WWW: <[https://apl.cnb.cz/apljerrsdad/JERRS.WEB07.INTRO\\_PAGE?p\\_lang=cz](https://apl.cnb.cz/apljerrsdad/JERRS.WEB07.INTRO_PAGE?p_lang=cz)>.

Instead of describing one intermediary type at a time, I focus on the “differentiating factors” between them. For the reader’s convenience, I outlined them in the following table based on the relevant articles 5 – 8 of the Intermediaries Act:

**Table 3. Synthesis of Insurance Intermediaries under Intermediaries Act**

Attribute	VPZ	PPZ	VPA	PA	PM
Acts in the name and on behalf of; has contract with; obliged by instructions of; <b>(a principal)</b>	Insurance undertaking (1 or more subject to conditions)	PA, VPA, PM	Insurance undertaking (1)	Insurance undertaking (1 or more)	Customer
May collect premium	no	no	yes	yes	yes
May pay benefit	no	no	yes	yes	yes
Liability for damage caused by the intermediary	Insurance undertaking	PA, VPA, PM	Insurance undertaking	PA	PM
Salaried by	Insurance undertaking	PA, VPA, PM	Insurance undertaking	Insurance undertaking	Insurance undertaking

I believe that rows 2-4 in the table are intelligibly displayed in the table and do not need any further comment, on the other hand rows 1 and 5 pose two “questions” that need to be explored more thoroughly.

The first question is related to the identification of a principal (in a sense discussed in chapter 2) on behalf of which the given intermediary (i.e. an agent per chapter 2) acts. The intermediary acts in the name and on behalf of the principal on the basis of a contractual relationship and, also, is bound by the instructions given by the principal. In this respect, there are three possible scenarios. Either the principal is an insurance undertaking or it is another intermediary – namely *independent agent*, *exclusive agent* or *broker* – or, lastly, it is the (prospective) policy holder himself.

*Tied agent*, *exclusive agent* and *independent agent* all have the insurance undertaking as their principal, where they differentiate is whether they may have more than one principal. The *independent agent* may act on behalf of multiple insurance undertakings and may distribute all their products. On the other side of the spectrum is the *exclusive agent* that acts on behalf of only one insurance undertaking. But here is the catch, it was established

that a natural or legal person may register with CNB as many intermediary types as they like, then how it is reconciled with the exclusiveness of the *exclusive agent*? The solution is found in the segmentation of insurance per Annex 1 to the Insurance Act that I depicted in chapters 1.2.1 and 1.2.2. That is, if a legal or natural person offers certain insurance classes per Annex 1 of the insurance undertaking, with which he or she is in the contractual relationship as the *exclusive agent*, then he or she is prohibited from distributing the very same classes as a different type of intermediary (as they are in competition). Thereby, the exclusiveness is maintained. Lastly, the *tied agent* combines the aspects of both the *independent* and *exclusive agent*. He or she may have more insurance undertakings as his or her principal, same as the *independent agent*, but only on the condition that he or she does not distribute the same classes of insurance for two or more insurance undertakings (here applies the logic of *exclusive agents*).

The case of the principal who is another insurance intermediary applies to *subordinated agents*. He or she acts in the name and on behalf of either the *independent agent*, *exclusive agent* or *broker* on the basis of a contractual relationship and, also, is bound by the instructions given by them. This opens the door to a business model where multiple agents work in the same company. That is, generally, there is one *independent agent* that employs many *subordinated agents*. Lastly, when the (prospective) policy holder himself is the principal, the agent is the *broker*.

I conclude the first point by observing that but for the possibility of the multiple registrations it would have been possible to draw a framework in which on the level 1 are the insurance undertakings, on level 2 are *independent agents*, *exclusive agents*, *tied agents* and *brokers*, and on level 3 *subordinated agents*. Regrettably, the possibility of multiple registrations precludes this.

The second question, which is directly linked to the first one, is the issue of remuneration. As a general rule, the principal pays the agent for his services. The only exception to the rule is the case of a *broker* who is by default paid by the insurance undertaking unless agreed otherwise with the customer and the insurance undertaking. That is, the *subordinated agent* is paid by either the *independent agent*, *exclusive agent* or *broker*.

While all other intermediaries are paid by the insurance undertakings as their respective principals.

The intermediaries are paid by commissions from the sold policies. The non-life insurance policies are not governed by law in this respect. The life insurance policies are regulated by Article 21e of the Intermediaries Act which stipulates the rules for spreading the commission into 5 years as discussed in chapter 1.2.1. Note that single paid life insurance and policies with commission spreading throughout the duration of the contract are excluded (Article 4). The rates of commissions differ by distribution channels and classes of insurance, however, according to market sources<sup>82</sup> the rates average from 15% to 20% for non-life insurance, for single paid life insurance it averages from 1% to 5% and for regular paid life insurance it ranges from 180% to 220% of the first year's premium.

### **3.1.2 Interweaving the Intermediary Types with Distribution Channels**

Identification of the agent's principal and the nature of their relationships facilitates the understanding of the concrete business model in which agents conduct their business and explains the channel split on internal and external, that I made in the *Table 2. Distribution Channels Framework* in chapter 2. With the intention not to mislead the reader, I wish to clarify at the very outset that despite many simplifications and assumptions, one can make, it is impossible to categorize the five different types of intermediaries into either the internal or external channel. It is a testimony to the unsatisfactory and baffling situation granted by the Intermediaries Act.

The key distinguishing factor between the two is the exclusiveness of the principal – agent relationship. That is to say, if the agent pursues the intermediation business solely for the benefit of one insurance undertaking, one principal, then he or she is to be regarded as an internal distribution channel of the given insurance undertaking. In this strictest sense, only direct employees (sales staff that underwrite insurance), who are omitted by the Intermediaries Act altogether, of the insurance undertaking would form its internal

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<sup>82</sup> Expert interviews with *subordinated agents* from Fincentrum, a.s. and Broker Trust, a.s.

distribution channels and all types of insurance intermediaries, per Intermediaries Act, would find themselves in the external distribution channel.

Provisions of the Intermediaries Act do not justify any other interpretation as the *exclusive* and *tied agents*, while being the most alike to direct employees, fail the exclusiveness test as it was explained in the previous chapter 3.1.1. However, based on CAP data, I am going to argue, in line with CNB<sup>83</sup>, that the *exclusive* and *tied agents* in fact serve as an internal distribution channel of the insurance undertakings. That is due to the discrepancy between the real operation of the market and the possibilities given by the law.

My hypothesis is that even when the *exclusive agent* or *tied agent* may distribute products of more than one insurance undertaking by the virtue of multiple registrations or offering non-competing products, as I explained in chapter 3.1.1, I will not be statistically relevant. For that end, I refer the reader back to *Chart 5. Insurance Undertakings ranked by GWP (CZK bln.), 2016* in chapter 1.3. There, it is patent that with the exception of PCS, NN and MetLife all other insurance undertakings<sup>84</sup> offer both life and non-life insurance. In the case of PCS and NN, the products are distributed solely via *independent agents*<sup>85</sup>, MetLife does make use of *exclusive* (268<sup>86</sup>) and *tied agents* (143<sup>87</sup>). I hold that it is rational to disregard (due to its market share) MetLife's *exclusive* and *tied agents* and, more importantly, work with the hypothesis that those *exclusive* and *tied agents* that work for the insurance undertakings that offer both life and non-life insurance will distribute both segments of one insurance undertaking instead of having life insurance in his portfolio based on one insurance undertaking and non-life insurance based on a different insurance undertaking<sup>88</sup>. This view is also supported by the data<sup>89</sup> about the multiple registrations of *exclusive* and *tied agents*. The only "significant" overlap is with *subordinated agents* (23% and 26% respectively). I read it in a sense that they started as

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<sup>83</sup> Official Information of the Czech National Bank of 21 January 2014 regarding management and control exercised by the insurance undertaking in relation to its distribution channel.

<sup>84</sup> That is those largest twelve displayed in the chart that have the combined market share of 94%.

<sup>85</sup> Mainly in the form of bancassurance as the bank acts as, and is registered as, an independent agent, in fact.

<sup>86</sup> 2016, per CAP individual members results

<sup>87</sup> Ibid.

<sup>88</sup> For cost reasons, better contractual offering, trainings provided by the insurance undertaking, etc. Confirmed via expert interviews.

<sup>89</sup> See note 70.

*subordinated agents* in some larger companies, there they got acquainted with products and representatives of a given insurance undertaking and then they started to cooperate as *exclusive* or *tied agents*.

Thus, I consider these two types of intermediaries along with the employees of the insurance undertaking that underwrite insurance are to be understood together with the employees as an internal channel. The distinction, from the perspective of a prospective policy holder, between employees and *tied* and *exclusive agents* is virtually non-existent, yet only the latter two fall within the ambit of the current Intermediaries Act. This unsatisfactory regulatory situation is to be rectified by the new Insurance Distribution Act that I will discuss in chapter 3.2. As already explained, the *subordinate agents* can have, among others, *exclusive agents* as their principals, thus they may also fall within the internal distribution channel despite the fact that generally they work in companies that are considered as external distribution channel. Such is the case of CP Distribuce, a.s. which is a company 100% owned by CP and registered as an *exclusive agent* for CP. It has 3440<sup>90</sup> *subordinated agents* that effectively form the internal distribution channel of CP.

However, the *independent agents* and *brokers* may effectively find themselves in the internal channel despite the wording of the Intermediaries Act tells otherwise. It is the case of a companies called captive agents and brokers. That is to say, even when they legally may distribute insurance of many insurance undertakings they are contractually bound with only one insurance undertaking. For instance, Kapitál pojišťovací a finanční poradenství, a.s.<sup>91</sup> is registered as an *independent agent* for insurance undertakings in the Vienna Insurance Group (KOOP, PCS, CPP) and it has 981<sup>92</sup> *subordinated agents* that physically distribute the insurance and is considered as part of the internal channel by KOOP.

To conclude the internal distribution channel, it is observed that it consists of employees, *tied agents* and *exclusive agents*. As a general rule, *subordinated agents*, *independent*

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<sup>90</sup> As of 25/2/2018 per CNB register.

<sup>91</sup> KOOP has 70% ownership stake, while VIG AG has 30% ownership stake.

<sup>92</sup> As of 25/2/2018 per CNB register.

*agents* and *brokers* form the external distribution channel but they may occasionally form the internal channel as well.

Turning to the external channel it has already been established that it consists of *independent agents* and *brokers* and *subordinated agents* that work for the former two. It is now time to explore in which form do they conduct their business. There are many forms in which the distribution can take shape, thus I will only discuss the most prevalent one: multi-level-marketing (henceforth “MLM”) agencies, pool agencies, brokers, bancassurance, aggregators and other<sup>93</sup>.

The MLM agencies and pool agencies are either joint-stock companies or limited-liability companies that are registered as *independent agents* for many insurance undertakings. Since the *independent agent* is a legal person in this case, it has to be represented by a responsible representative<sup>94</sup>. However, the representative does not in fact distribute insurance as the actual intermediation is conducted by the *subordinated agents* that are registered with the given *independent agent*. The distinguishing factor of MLM agencies, in comparison to Pool agencies, is the ingloriously known pyramid structure that is made of the *subordinated agents*. In the pyramid structure the *subordinated agents* receive commissions from the policies they sold plus they earn a share of the commission generated by *subordinated agents* in lower levels of the pyramid structure. The MLM agencies also have regular employees who provide the back office, trainings, marketing, brand management, etc. for the *subordinated agents*. The pool agencies, on the other hand, are way less centralised, lack the pyramid structure, and their purpose is only to provide back office support, trainings, marketing, brand management for the *subordinated agents* but in a much smaller scale than is the case of MLM agencies.

The case of broker companies is much more complicated and embodies the total failure of current regulation. I will explain the first part of the failure on the case of the largest (by reported revenues) broker company on the Czech market – Renomia, a.s.<sup>95</sup>. Renomia

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<sup>93</sup> Other includes mainly so called fleet insurance – e.g. travel agencies, car dealers, etc.

<sup>94</sup> Per Article 11 of the Intermediaries Act

<sup>95</sup> See statistics compiled by server opojisteni.cz. Accessible at Opojisteni.cz [online]. 2017 [cit. 2018-02-25]. Statistics of intermediaries. Available at WWW: <<http://www.opojisteni.cz/pojistovaci-zprostredkovatele/top-30-pojistovacich-makleru-za-rok-2016-v-cesku-dle-opojisteni-cz/>>.

is a joint-stock company that is registered as the *broker* and *independent agent* at the same time. Similarly as in the case of MLM agencies, it has to be represented by a natural person. There are two representatives stemming from the two registrations as the *broker* and the *independent agent* and both are the same person. As the *independent agent* Renomia is registered with 20<sup>96</sup> insurance undertakings which products it distributes and it has 129 *subordinated agents* for the *independent agent*. On the basis of Renomia's registration as the *broker*, it has 136 *subordinated agents* for *brokers*. When one exports the list of *subordinated agents* listed for the *broker* registration and *independent* registration, it is revealed that 127 of them are identical, that is basically all of them. That means that the Renomia on the basis of its *broker* registration acts on behalf of the (prospective) policy holder as its principal, while at the same time it acts as in *independent agent* on behalf of the insurance undertakings as its principal. And, it acts by the means of *subordinated agents* who are on paper different but in fact are the very same people. There is nothing in the law that forbids such a conduct but clearly it goes against the intention of the law, to say the least. It amounts to a major conflict of interest if the person proclaims to be a representant of a (prospective) policy holder and thereby acquire his trust while at the same time he or she is an agent of the insurance undertaking.

Unfortunately, the second failure of the regulation is, in my view, even more radical. The second and the third broker companies with highest revenues on the Czech market are Marsh, s.r.o. and Aon Central and Eastern Europe, a.s. Following the example of Renomia they are both registered as *independent agents* in relation to the insurance undertakings and as *brokers* in relation to (prospective) policy holders. Also, they have real persons as representatives for the two types of intermediation. However, where they differ from Renomia are the *subordinated agents* as they have none<sup>97</sup>. Practically what happens is that the *broker* has its own direct employees who distribute the insurance on its behalf exactly in the same way as the insurance undertaking has its employees that distribute insurance. The key question is: are the employees obliged to observe the obligations stipulated by the Intermediaries Act for the *broker* by the virtue of their employment or they fall outside of the ambit of the law in a same way as the direct employees of the

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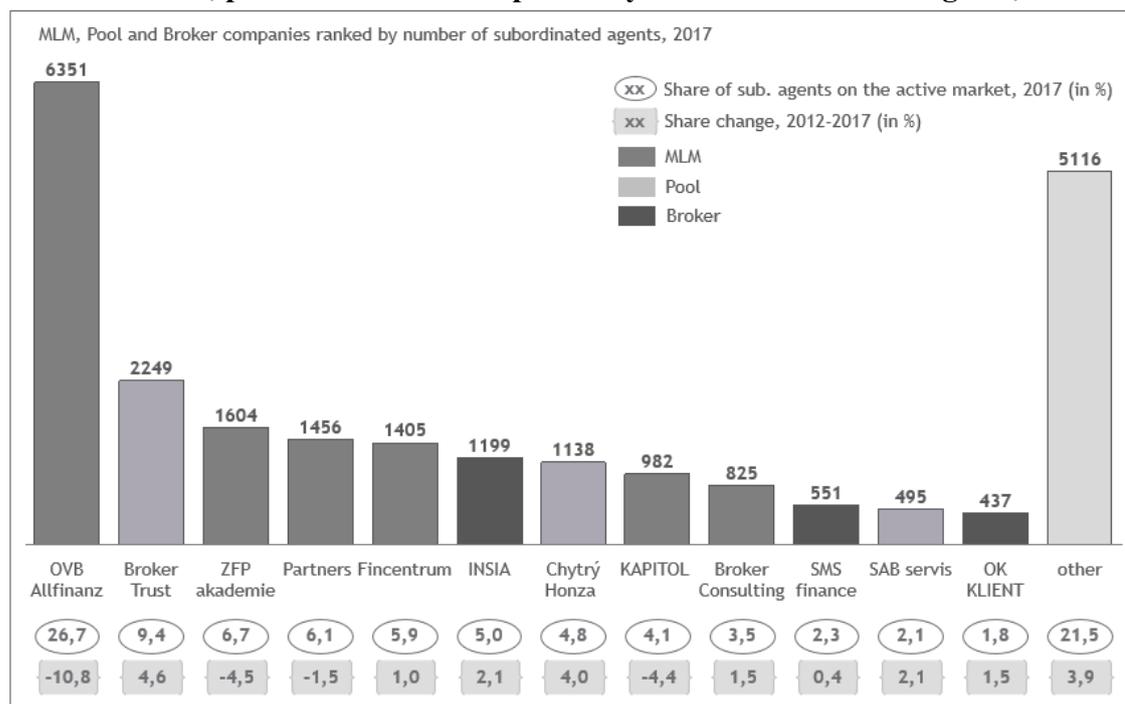
<sup>96</sup> This and following figures are as of 25/2/2017.

<sup>97</sup> In fact there is 1 registered.

insurance undertaking do? The Intermediaries Act is silent, again, about this matter and I cannot really explain it with all honesty. I am reluctant to believe it but I am afraid that it is really the case that brokers' employees are not covered by the Intermediaries Act as it always refer only to legal (in that case there is the representative according to Article 11) or natural person registered as the intermediary type and the employees of the *broker* are simple not *brokers* themselves. One can make the valid objection that this is only relevant to legal persons registered as brokers and not brokers as real persons who distribute insurance. I understand the point, however, the data<sup>98</sup> says that only 149 out of 782 registered brokers are in fact real persons, thus it renders the objection unsubstantial as the majority of the GWP will be distributed by the natural persons.

To give the reader an overview of the MLM, pool and brokers market in 2017, I exported the figures for the largest players by number of *subordinated agents* from the registry.

**Chart 6. MLM, pool and broker companies by no. of subordinated agents, 2017<sup>99</sup>**



<sup>98</sup> See note 70.

<sup>99</sup> Other includes Swiss Life Select Česká republika s.r.o.; PRVNÍ MORAVSKÁ SPOLEČNOST, spol. s r. o.; Holver s.r.o.; Bohemia Servis Finance a.s.; Pernamenta a.s.; Allrisk, a.s.; OK GROUP a.s.; DataLife a.s.; M & M pojišťovací s.r.o.; UniCredit pojišťovací makléřská spol. s r.o.; Salve Finance, a.s.; OPEN FINANCE s.r.o.; Sillet Group a.s.; RENOMIA, a. s.; GEPARD FINANCE a.s.; FG Financial Group, a.s.; I. Vzájemná poradenská a.s.; M.S.QUATRO, s.r.o.; ČSOB Leasing pojišťovací makléř, s.r.o.; AKROPOL nezávislé finanční poradenství a.s.; plus I added 10% of the total to make for the rest of the active market as an estimate.

The market is fairly consolidated, with OVB Allfinanz as a clear leader with 26,7% market share. Also, note that all types of agencies – MLM, Pool and broker – are represented in top twelve.

The other external channel I want to discuss is bancassurance. It works on a similar flawed basis as the broker companies in that respect that the bank is either registered as the *independent agent* or *tied agent* but the actual distribution is conducted by bank employees who fall outside of the ambit of the Intermediaries Act.

From the legal perspective, the aggregators operate also in a similar manner as broker companies as the two largest aggregators<sup>100</sup> – epojisteni.cz and klikpojisteni.cz – have the same legal arrangement as Renomia, a.s. and Aon Central and Eastern Europe, a.s. That is, both are registered as *independent agents* with multiple insurance undertakings and as *brokers* at the same time, while only the former has some *subordinated agents* while the latter rely solely on direct employees. Since the business model of the two is completely identical, one has to draw the conclusion that under the current Intermediaries Act it is up to the market players whether they wish to be bound by the Act and register with CNB or they do not.

To conclude, by the means of an analysis of every type of insurance intermediary stipulated by the Intermediaries Act read against the real market operations provided by CNB registry and market intelligence, it has been possible to understand which distribution channels outlined in chapter 2 in the *Table 2. Distribution Channels Framework are in fact covered by the regulation*. I summarize it as follows:

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<sup>100</sup> By revenues released in their financial statements. Other analyzed players include top-pojisteni.cz, srovnovac.cz, povinne-ruceni.com, srovnator.cz, ruceni.cz, ipojisteni.cz, salvepojisteni.cz, porovnej24.cz

**Table 4. Distribution Channels Framework under Intermediaries Act**

	CZK ~122 bln. Gross Written Premium, 2017										
	Insurance undertakings										
	Internal channel					External channel					
						Independent					
In person Branch Online Telephone	Employees	exclusive agents Tied and Captive agents and brokers	Banks	Other	MLM & Pool	Brokers	Banks	Aggregators	Other	Subordinated agent Tied agent Exclusive agent Independent agent Brokers	
	✗	✓	✓	✗	?	✓	?	✗	?	?	

The ticks and crosses are self-explanatory. The question marks imply that some players are regulated fully, some partly and some not at all. It is concluded that it is due to the fact that only some have registered and the supervisory authority has not been able to provide any clear guidelines who have to register and then enforce the guidelines. It is striking the most in the case of brokers and bancassurance. They are both discussed in the explanatory memorandum but the legislator practically failed to encompass them within the law as the actual distribution is conducted by the employees of the registered brokers or independent agents (banks).

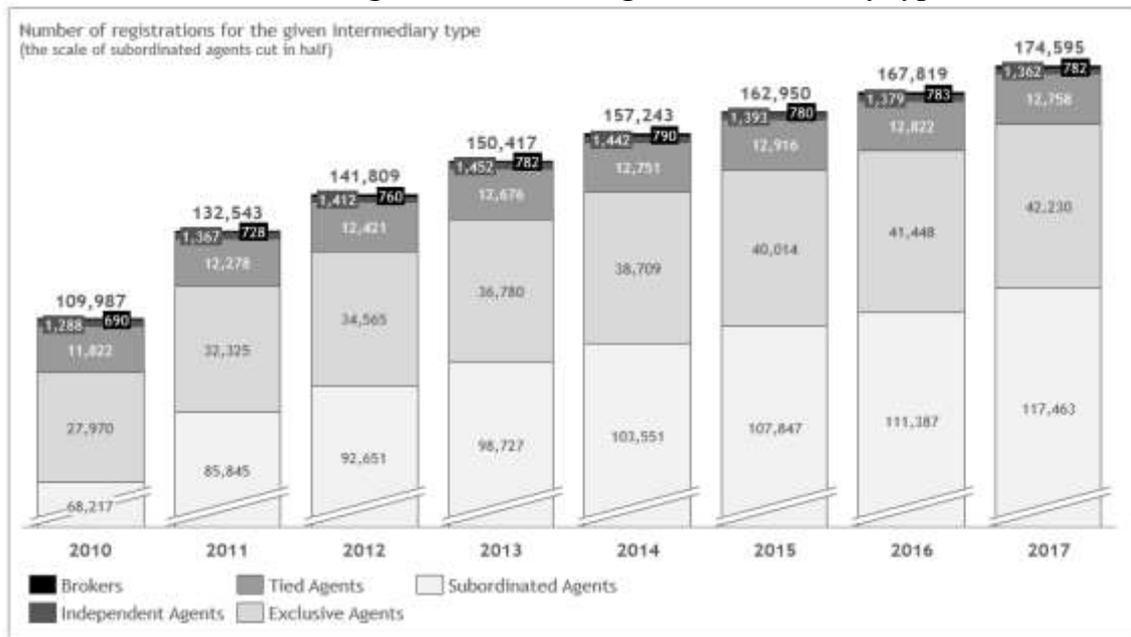
### 3.1.3 Quantification of Intermediaries

The fact that no-one, not even the legislator that drafted the Intermediaries Act and now is drafting the prospective Insurance Distribution Act, cannot quantify, in late 2010s, the number of people impacted by the regulation is striking to say the least. Thus, In this chapter, I wish to estimate for the first time what is the real number of intermediaries as natural persons that distribute insurance. I believe that with a reasonable (~20%) accuracy it is possible to model the market based on only two primary data sources that were already discussed – CAP and CNB – and on secondary market sources that inform us about the most relevant market players.

As already pointed out, all intermediaries register with CNB. Unfortunately, CNB, at this point, under the effective Intermediaries Act, does not erase those intermediaries that are

no longer active unless they themselves submit an application to be removed from the register. I visualize the CNB data<sup>101</sup> into the following chart.

**Chart 7. The number of registrations for the given intermediary type 2010 – 2017**



The ~175 ths. of registrations in 2017 are clearly far-fetched from the number of active registrations. The first task is then to model how many of these are no longer active. Taken as a whole it is an insurmountable problem, however, if one goes by the segment it is possible.

The easiest to start with are *brokers* and *independent agents*. It is patent from the chart that they are, along with *tied agents*, those that did not see their numbers grow and, in fact, they plateaued in the observed period. According to the Intermediaries Act<sup>102</sup>, both *brokers* and *independent agents* are obliged to be insured against damage caused in the course of their business conduct. Thus, my hypothesis is that, in the case of the two types discussed, those who discontinue their intermediary activities erase themselves from the

<sup>101</sup> Can be downloaded into an excel at Apl.cnb.cz [online]. 2018 [cit. 2018-02-17]. Register of Intermediaries. Available at WWW:

<[https://apl.cnb.cz/apljerrsdad/JERRS.WEB07.INTRO\\_PAGE?p\\_lang=cz](https://apl.cnb.cz/apljerrsdad/JERRS.WEB07.INTRO_PAGE?p_lang=cz)>.

<sup>102</sup> Article 7, Subsection 4 and Article 8, Subsection 5 of the Intermediaries Act.

registry as otherwise they would have to pay (it is a substantial amount) for the policy they do not need.

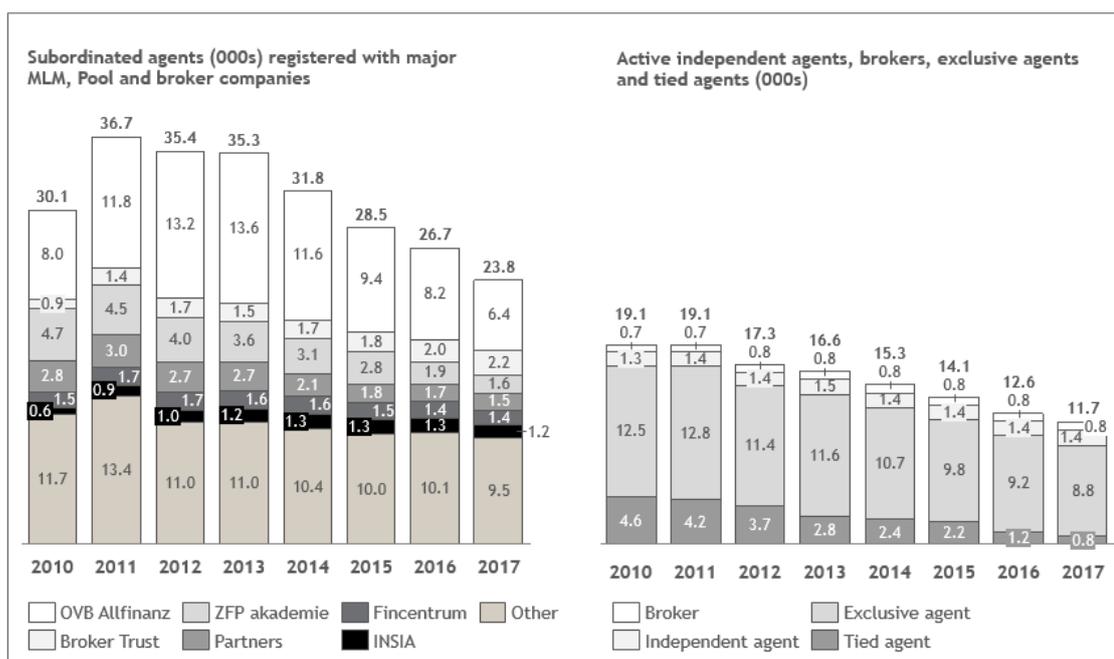
The next two types, that I will deal with together, are *tied agents* and *exclusive agents*. Here, I will make use of the CAP statistics that I have widely used in chapter 1. The CAP's individual members' results also include the number of *tied agents* and *exclusive agents* that work for individual insurance undertakings. Since it was established that the insurance undertakings included in CAP's statistics represent 97% of the GWP of the Czech market, it is valid to draw the conclusion that only those that are present in the CAP's statistics are active. The most recent data (2016) inform us that 90% of *tied agents* and 78% of *exclusive agents* registered with CNB were inactive in that year.

The *subordinated agents*, the largest and fastest growing segment, work within the MLM, pool and broker companies (see chapter 3.1.2 for further details). These companies, obviously legal persons, are registered with CNB as *independent agents* or *brokers* so they are flexible in both the insurance undertakings and insurance classes that they distribute. The market is fairly consolidated, similarly as the market of insurance undertakings<sup>103</sup>, thus it is feasible to map it. Therefore, once one has a list of MLM, pool and broker companies that represent the majority of the market, it is possible to find the given companies in the registry and find out the number of *subordinated agents* registered with it. Also, it is possible to go back in time and see the figures for past dates, thus it is possible to produce time series. The attentive reader should question this approach at this point as it has been said that CNB does not erase the inactive intermediaries from the registry. However, in this case, the *independent agents* and *brokers* themselves remove the *subordinated agents* who no longer work for them from their registry files. That is to say, the subordinated agents still stay in the register but they are no longer connected with the given *independent agent* or *broker*. The learnings can be visualized into the following two charts:

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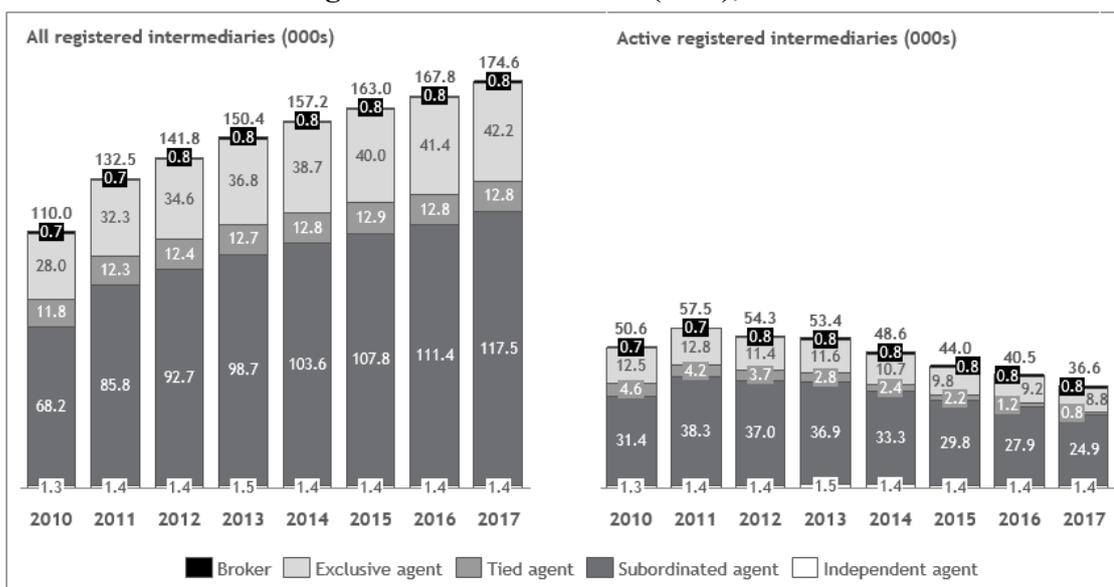
<sup>103</sup> Refer to Chart 3. Insurance Undertakings ranked by GWP (CZK bln.), 2016 in chapter 1.3.

**Chart 8. Active Intermediaries on the Czech Market 2010 – 2017<sup>104</sup>**



Then referring back to the *Chart 7. The number of registrations for the given intermediary type*, it can be compared with the active intermediaries represented on the *Chart 8. Active Intermediaries on the Czech Market*. Synthesizing all the learnings together we can see that the number of registered intermediaries who are active has, in fact, been decreasing across all types since 2011.

**Chart 9. All vs active registered intermediaries (000s), 2010 – 2017**



<sup>104</sup> See note 99.

Last thing left for analysis is the actual number of unique active individuals<sup>105</sup> who are registered as insurance intermediaries. Utilizing my model<sup>106</sup>, I have calculated that the total number of all registrations, that is ~174 ths., translates into ~158 ths. unique individuals. Unfortunately, it cannot be inferred which of those unique individuals are those that are also active. Thus, I apply the ratios that I have for all registrations (e.g. only 10% of *brokers* are registered only as brokers while on the other side of the spectrum 89% of *subordinated agents* have only this one registration) to the estimated active registrations. Thereby, the ~36,5 thousands active registrations in 2017 translates into ~32 thousands unique individuals who distribute insurance as insurance intermediaries under the Intermediaries Act. Only after doing these calculations, I read the explanatory memorandum to the proposed Insurance Distribution Act which states<sup>107</sup> that it estimates<sup>108</sup> that there are ~30 thousands unique active individuals who distribute insurance and are registered with CNB. It strengthens not only the final figure I reached, but much more importantly it indirectly validates the assumptions that I made for all the types of insurance intermediaries.

### **3.2 Distribution under Insurance Distribution Act**

In the previous chapter on Intermediaries Act, I have selectively raised only certain issues, that I deemed the most important, to the reader's attention. In this chapter, I will be faithful both to the approach and to the scope of inquiry. That is, I will try to convey to the reader how the new regulatory framework will impact the issues that were under scrutiny in the preceding chapter.

The proposed Insurance Distribution Act (henceforth "IDA") not only transposes the IDD, but also accommodates the specific issues of the Czech insurance market. Since the proposal is not expected to be subject to any major changes, I will work with as the prospective new regulatory environment and I will bypass the analysis of the IDD itself as I do not see much added value in referencing IDA's articles to IDD's mirrored articles.

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<sup>105</sup> Legal persons have to be represented (per Article 11 of the Intermediaries Act) by real persons so I am truly counting individuals.

<sup>106</sup> See note 70.

<sup>107</sup> See notes to the Article 120 of the proposed Insurance Distribution Act.

<sup>108</sup> I assume that the estimate was made by the relevant department of the Ministry of Finance.

### 3.2.1 Extended Scope and Novel Categories of Intermediaries

I hold that it is not exaggerated to state that IDA amounts to a legislative revolution in the regulation of insurance distribution. This thesis is written in the close time proximity to the date when the IDA supersedes the Intermediaries Act, and thus one may argue that I should have disregarded the pre-IDA legislation altogether and focus solely on the upcoming legislation. I admit the soundness of the argument, though I conceive the IDA as a legislation tailored to rectify the current market failures and, thereby, the reader who is not acquainted with the contemporary legislation could fail to grasp the main issues that are being addressed.

Per Article 1, the subject matter of IDA is the conduct of legal or natural persons who pursue the distribution of insurance and reinsurance, their rights and obligations and the relevant competences of administrative authorities. In these general terms the Article 1 is similar to the mirror article of the Intermediaries Act. However, the provisions that give specific content to the laid down subject matter amount to a significant departure from the current regulation.

Firstly, the scope is much wider. In the chapter 3.1.2 on the Intermediaries Act, I bewailed its partial scope that resulted in most of the distribution channels falling, completely or partially, outside of its ambit. It was due to the fact that employees of the insurance undertakings, banks, *independent agents*, *brokers* and others were not covered. Under IDA, this is rectified. Conceptually, it segments distribution of insurance<sup>109</sup><sup>110</sup> into provision of insurance<sup>111</sup> and intermediation of insurance<sup>112</sup>. The former applies to insurance undertakings and the latter to insurance intermediaries. Thus, insurance undertakings are recognized as insurance distributors that merit the equal legislative treatment as the insurance intermediaries. Their employees, but also employees of insurance intermediaries, found their legislative definition<sup>113</sup> in the Act. It encompasses

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<sup>109</sup> Article 2, letter a) of IDA.

<sup>110</sup> Identically the distribution of reinsurance is regulated by IDA. Nearly everything that is written in the chapter on the IDA and on the Intermediaries Act also applies to reinsurance. For the sake of clarity, I have decided not to mention reinsurance as there would be little added value in doing so (e.g. instead of insurance undertaking there should be insurance undertaking or reinsurance undertaking, etc.).

<sup>111</sup> Article 2, letter c) of IDA.

<sup>112</sup> Article 2, letter e) of IDA.

<sup>113</sup> Article 2, letter k) of IDA.

all persons in employment relationship with insurance undertakings or insurance intermediaries if they directly take part in the distribution of insurance or are directly responsible for the distribution.

In the chapter 3.1. (and its subchapters), it proved laborious to ascertain what all the different intermediary types under Intermediaries Act really stand for. For that end, I had to rely heavily on the meticulous work with the CNB registry and market research. The IDA embraces the call for simplification of the intermediary types and prohibition of multiple registrations.

Thus, the IDA distinguishes only four types of insurance intermediaries<sup>114</sup>: 1) independent intermediary (further segmented on insurance agent and insurance broker); 2) tied intermediary; 3) ancillary insurance intermediary; 4) insurance intermediary resided in another member state. Their main characteristics are dispersed throughout the IDA and I produced the following table, similar to the one applicable to the Intermediaries Act, to record them in an intelligible manner.

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<sup>114</sup> Article 2 of IDA.

**Table 5. Synthesis of Insurance Intermediaries under IDA<sup>115</sup>**

Attribute	Independent intermediary [§ 6]		Tied intermediary [§ 15]		Ancillary insurance intermediary [§ 24]	
	Insurance Agent [§ 12/1 letter a)]	Insurance Broker [§ 12/1 letter b)]				
Acts in the name and on behalf of; has contract with; obliged by instructions of; <b>(Principal)</b>	<b>1 ≡ insurance undertakings</b> [§ 12/1 letter a)]	<b>1 ≡ customers</b> [§ 12/1 letter b)]	1 insurance undertaking <b>OR</b> 1 reinsurance undertaking <b>OR</b> 1 independent intermediary <b>OR</b> 1 foreign insurance intermediary [§ 15/2, § 2 letter j)]		1 ≡ insurance undertaking <b>OR</b> 1 ≡ reinsurance undertaking <b>OR</b> 1 ≡ independent intermediary <b>OR</b> 1 ≡ foreign insurance intermediary [§ 24/3, § 2 letter j)]	
May collect premium and pay benefit to a customer	<b>Yes</b> , subject to a contract with the insurance undertaking [§ 54/3]	<b>No</b> , in the case of <b>endowment and unit-linked insurance</b> <sup>116</sup> [§ 54/1]	<b>Yes</b> , subject to a contract with the principal [§ 54/4]	<b>No</b> , in the case of <b>endowment and unit-linked insurance</b> <sup>117</sup> [§ 54/1]	<b>Yes</b> , subject to a contract with the principal [§ 54/4]	<b>No</b> , in the case of <b>endowment and unit-linked insurance</b> <sup>118</sup> [§ 54/1]
Liability for damage caused by the intermediary	<b>Independent intermediary</b> [§ 14]		<b>Principal</b> [§ 23]		<b>Principal</b> [§ 32]	
Requirement of trustworthiness	<b>yes</b> [§ 7/1 letter b)]		<b>yes</b> [§ 17/1 letter c), § 70]		<b>yes</b> [§ 26/1 letter c), § 70]	
Level of professional competence	<b>yes</b> [§ 7/1 letter c)]		<b>yes</b> [§ 17/1 letter c), § 56 ]		<b>yes</b> [§ 26/1 letter c), § 56 ]	
Who submits the application for registration and pays the admin. fee	<b>Intependent intermediary or insurance undertaking</b> [§ 7/1,2 ]		<b>Principal</b> [§ 16/1, §18/5]		<b>Principal</b> [§ 26/1]	
Can be registered as different intermediary type at the same time	<b>no</b> [§ 7/1 letter f)]		<b>no</b> [§ 16 letter b)]		<b>no &amp; not a credit institution</b> [§ 25 letter b)]	
Registered for (after paying the administrative fee)	<b>12 months</b> [§ 9/2]		<b>12 months</b> [§ 18/4]		<b>12 months</b> [§ 27/3]	

If one reads this table against the *Table 5. Synthesis of Insurance Intermediaries under Intermediaries Act*, he or she probably wonders how do the old categories of intermediaries translate into the new ones. The general assumption is that the *independent agents* and *brokers* would reregister<sup>119</sup> as independent intermediaries and *subordinated agents, exclusive agents* and *tied agents* would be reregistered by their principals as tied intermediaries. Ancillary insurance intermediaries stand somewhere in between and will attract, according to my understanding, mostly *independent agents* and *exclusive agents*. Ancillary insurance intermediaries may only distribute insurance that is a supplementary service to the main good or service that is the subject of his or her main professional

<sup>115</sup> I omitted the insurance intermediary resided in another member state (as I did in Table 4. Synthesis of Insurance Intermediaries under Intermediaries Act in the case of the *foreign intermediary*) as it is an intermediary sui generis.

<sup>116</sup> See chapter 1.2.1 for the definition and further details of endowment and unit-linked insurance. Also, Article 2, letter n) of IDA gives the definition.

<sup>117</sup> Ibid.

<sup>118</sup> Ibid.

<sup>119</sup> The process of reregistration after the IDA comes into effect is outlined in the articles 120 -122.

activity<sup>120</sup> and it is not, inter alia, a bank.<sup>121</sup> Thus, it will be the case of various car dealers or travel agents who will reregister as ancillary insurance intermediaries<sup>122</sup> and are represented as other in my distribution channel framework.

It is already patent from the *Table 5. Synthesis of Insurance Intermediaries under IDA* who are the principals of individual intermediaries and that the multiple registrations are forbidden. Thus, it is possible to draw the distribution pyramid whose impossibility, under Intermediaries Act, I lamented in chapter 3.1.1. Further, as already mentioned, IDA adds employees of all distributors into the scope of the law and, thereby, into the distribution pyramid.

**Table 7. Hierarchy of insurance distributors under IDA<sup>123</sup>**

Insurance undertakings					
Employee	Tied intermediary	Independent intermediary			Ancillary ins. intermediary
	Employee	Employee	Tied intermediary	Ancillary ins. intermediary	Employee
			Employee	Employee	

I have already touched upon the issue of reregistration in the preceding paragraphs, when I forecasted the new roles, per IDA, in which the legal and natural persons registered under the Intermediaries Act will end up. Here, I would like to deal with the incoming transition per se that is envisaged in the transitional provisions<sup>124</sup> set out in Part IX of IDA.

From the date IDA comes into effect (henceforth “roll out date”) , the intermediaries registered under the Intermediaries Act may continue to pursue the distribution of insurance products subject to a condition. Which is as follows: within the period of 3 months, either he or she applies for the license (to the CNB) of the independent

<sup>120</sup> Article 24/2 of the IDA.

<sup>121</sup> Article 25/1 letter b) of the IDA.

<sup>122</sup> For example, Auto-diskont, s.r.o (a car dealer) is registered as *independent agent* for Koop, Generali and CPP, on the other hand, CK Alpin-tour, s.r.o (a travel agent) is an *exclusive agent* for CPP.

<sup>123</sup> Article 47 of the IDA.

<sup>124</sup> Articles 119 – 124 of IDA.

intermediary or the principal reports him or her as the tied intermediary or ancillary insurance intermediary.<sup>125</sup> The principal who reports the tied intermediaries and ancillary insurance intermediaries can also be the applicant for the license of the independent intermediary.<sup>126</sup> The CNB will either accept or decline the application and inform the applicant of the decision (that is, prospective independent intermediary or principal in the case of tied intermediaries and ancillary insurance intermediaries).<sup>127</sup> During the interim period between the roll out date and the CNB decision<sup>128</sup> or the expiry of the time-limit (3 months) the intermediaries are obliged to adhere to the Articles 71 – 92 of IDA and to Articles 1 – 20 and 22 – 31 of the Intermediaries Act.<sup>129</sup> That is, the organisational requirements and supervision will be governed by the Intermediaries Act, while the information requirements and conduct of business rules will be governed by IDA.

The main concern with the transition, as I understand it, is this one: the legal and natural persons have multiple registrations under the Intermediaries Act, as was discussed in chapter 3.1, thus there can be a clash of registrations when it comes to tied intermediaries. That is, the first scenario is that two or more principals would report one insurance intermediary type under Intermediaries Act, e.g. *subordinated agent*, as their tied intermediary. The second scenario is that two or more principals would report different intermediary types under Intermediaries Act, e.g. *tied agent* and *subordinated agent*, who happen to be in fact one and the same legal or natural person. Since IDA forbids multiple registrations it is absolutely crucial with whom the tied intermediaries will be registered. IDA resolves this problem by applying the first come, first served approach<sup>130</sup>, when it comes to reporting. And, based on my understanding that is not supported by IDA but I assume that the upcoming implementing provisions will establish such an approach, it obliges the principal to have a written contract with the prospective tied intermediary prior to making the application.<sup>131</sup> Should the regulation lack the requirement to have the

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<sup>125</sup> Article 120/1 of IDA.

<sup>126</sup> Article 121 of IDA.

<sup>127</sup> Article 120/1 of IDA.

<sup>128</sup> Max 6 months in the case of independent intermediaries per Article 120/2 of IDA. Max 5 days in the case of tied intermediaries and ancillary insurance intermediaries per Article 16/2 and Article 25/2 of IDA.

<sup>129</sup> Article 120/3 of IDA.

<sup>130</sup> Article 18/2 of IDA.

<sup>131</sup> Article 15/2 of IDA implies that the written contract between the tied intermediary and his or her principal is concluded after the tied intermediary is reported in the register.

written contract with the prospective tied intermediary prior to the application for registration, it would open the door to a major moral hazard by the insurance undertakings. They would report on the first minute of the roll out date the legal or natural persons that had been working for their competitors. As the market is so consolidated (see chapter 1.3), one can imagine for instance VIG group leverage their financial strength and take over all the *tied agents* and *exclusive agents* of Generali group, thus effectively liquidating them. Further, what adds gravity to this legislative gap is the fact that there are no provision in IDA that would enable the reported tied intermediaries to de-register themselves on their own will. Nevertheless, even if this gloomiest possibility would be eventually rectified by the implementing provisions, then still very fierce competition for the best-performing intermediaries is expected.

### 3.2.2 In Transition I: Distribution Channels

IDA’s extended scope and novel categories of insurance intermediaries is reflected in the following updated table of distribution channels framework:

**Table 6. Distribution Channels Framework under IDA<sup>132</sup>**

	CZK ~122 bln. Gross Written Premium, 2017										Tied intermediaries <b>Independent</b> intermediaries Ancillary insurance intermediary
	Insurance undertakings										
	Internal channel			External channel							
	Employees	Tied agents	Captive agents and brokers	Exclusive		Independent					
Banks				Other	MLM & Pool	Brokers	Banks	Aggregators	Other		
In person Branch Online Telephone	→	→	→	→	→	→	→	→	→	→	→
	↓	↓	↓	↓	↓	↓	↓	↓	↓	↓	↓
	✓x	✓	✓	✓x	✓?	✓	✓?	✓x	✓?	✓?	

I will use the following paragraphs to capture the transformation that every channel in the *Table 9. Distribution Channels Framework under IDA* will have to undergo under IDA. Note that the insurance undertakings and independent intermediaries are obliged to<sup>133</sup> set up policies to ensure that all the legal and natural persons that are in the *Table 7. Hierarchy of insurance distributors under IDA* comply with the obligations laid down by

<sup>132</sup> Note: the scaled down ticks, crosses and question marks represent the state of regulation under Intermediaries Act.

<sup>133</sup> See Article 48/1 letter a) of IDA.

IDA. It will translate into related costs: e.g. registration fees as the intermediaries will have to reregister, costs related to passing new professional exams or trainings for the new code of conduct, etc.

### **Employees**

The employees that directly underwrite insurance (henceforth “direct sale staff”) will have to newly adhere to IDA’s obligations. It might appear that it will translate into highest costs for the insurance undertakings that stem from the regulation. I argue that this is not the case, per CAP there were only 2,492 direct employees underwriting insurance in 2016. Those were highly concentrated as Koop, CP and CPP were insurance underwritings for whom 91% of the direct sale staff worked in that year. Apparently, direct sale staff is not a very important channel.

### **Tied agents**

As it was quantified in chapter 3.1.3 there were 9,220 *exclusive agents* and 1,219 *tied agents* working for the insurance undertakings in their internal channel along with employees. It is expected that they will be reregistered as tied intermediaries with their principals. Along with captive agents and brokers, I assume that they will represent the highest additional costs for the insurance undertakings (thanks to their sheer numbers).

### **Captive agents and brokers**

This is the case of companies such as Kapitál pojišťovací a finanční poradenství, a.s. or ČP Distribuce, a.s. These are *independent agents* or *exclusive agents* who work exclusively for one insurance undertaking (or one group) and have many *subordinated agents* registered with them. They will submit an application to be reregistered as independent intermediaries and during the period of evaluation of their application they are allowed to register the former *subordinated agents* as their tied intermediaries.<sup>134</sup>

### **Banks**

The situation of banks’ employees is legally similar to the one of insurance undertakings’ employees. That is, newly they will be covered by the legislation and the bank will have

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<sup>134</sup> Article 121 of IDA.

to register itself as an independent intermediary. However, from the practical point of view, it will be way more difficult. Based on mystery shopping, the current situation is as follows: all the branch employees who deal with the bank's customers regularly contract the insurance policies. As distributors of insurance that are covered by IDA, they will have to, inter alia, pass the professional exams. One cannot imagine that all the banks employees (there are thousands of them as there are at least 2,000 bank branches in the Czech Republic alone) would go and pass the professional exams. Thus, I expect organizational changes within the banks employee staff that will result in selecting only a handful of employees who will be dedicated to insurance and will pass the professional exams.

### **MLM, pool and broker companies**

I foresee the greatest disruption in the intermediary market to take place in the MLM channel. Prima facie, they should be stable as the MLM companies do not share any common *subordinated agents*<sup>135</sup>, thus one would expect limited competition for the tied agents stemming from the prohibition of multiple registrations. However, the Article 49/2 of IDA could render the MLM business model unlawful. It precludes, inter alia, insurance intermediaries from earning a share of the commission generated by intermediaries that they brought into the company. The explanatory memorandum brings certain ambiguity into the meaning of the article as it states that the article should not be interpreted as restricting current business model. If the application of the article is to be carried out in a manner in which I understand it, it would translate into a complete dismantling of the whole MLM market.

The market of pool companies is expected to undergo a further consolidation phase. The increased costs brought about by IDA (e.g. information requirements, code of conduct rules, requirement of continuous education, etc.) will see smaller / stand-alone players to loose competitiveness and go out of the business. They pool companies will make use of the economies of scale and will provide efficiently back office support, trainings, marketing, brand management to the large numbers of semi-independent tied intermediaries.

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<sup>135</sup> Empirically verified with the register's data.

### **Aggregators and other**

Those aggregators, that are already registered under Intermediaries Act, will re-register themselves as independent intermediaries and those, who have not registered under Intermediaries Act but are pursuing the conduct of insurance distribution, will have to register themselves for the first time in order to comply with the new regulation. Lastly, others include, inter alia, various car dealers or travel agents who will reregister as ancillary insurance intermediaries.

### **3.2.3 In Transition II: Legal Obligations of Intermediaries**

This chapter about the intermediaries' legal obligations that stem from the two regulations represents arguably the most important part of the debate about the intermediaries. I have deliberately put it at the end of the body of this thesis, including the discussion of legal obligations under IA. I have postponed the discussion for the reason that at first I wanted to firmly establish who is and who is not affected by the legal obligations under the both acts. And then, by synthesizing the relevant articles chart the transition from the old regulation to the new one.

The legal obligations are to be understood, ultimately, as safeguards, designed for the benefit of a prospective policy holder, against intermediaries misconduct and dishonest practices. Conceptually, both under IA and IDA, the legal obligations can be categorized into three categories: 1) the requirements and steps on has to fulfill or undergo in order to be registered as a given type of intermediary; 2) the code of conduct to which an intermediary has to adhere to when distributing insurance; 3) supervision and sanctions if the code of conduct is violated.

The first category is understood as a filter or a barrier to entry and, thus, it contains preconditions of successful registration. It revolves around two main topics: professional competence and trustworthiness. The second category details the actual interaction between the prospective policy holder and the intermediary. By definition, there is an information asymmetry between the two and the relevant provisions of the two acts try to rectify this asymmetry. The third category includes supervision conducted by the CNB

and ensuing reporting obligations of the intermediaries, CNB's jurisdiction to impose fines and measures to remedy the situation should the intermediary acts against the law, and lastly it deals with administrative offences. In this thesis, I have decided to focus only on the first two categories as they offer a plenty of room for analysis and I deem them the most important.

### **Preconditions of succesul registration**

Both under IDA and Intermediaries Act, in order to be registered the applicant has to pass the professional competence<sup>136</sup> requirements which has two component parts - general knowledge requirements and expertise requirements<sup>137</sup>. In this part, I will explain what they are and outline the transition from IA to IDA.

The former is satisfied by the obtainment of a secondary school degree in the case of IA<sup>138</sup>. The new regulation tightens up the general knowledge requirement as the intermediaries will have to have at least a baccalaureate.<sup>139</sup> The intermediaries registered prior to IDA's roll out date and lacking a baccalaureate will have 42 months to obtain it.<sup>140</sup> Further alleviating exception is embedded in IDA's transitional provisions, where it stipulates that those who had distributed insurance, i.e. not only registered intermediaries but also employees<sup>141</sup>, continuously for three years prior to IDA's roll out date, are exempted from the obligation.<sup>142</sup> Thus, when one takes into account the two exceptions, it is submitted that it will have a limited impact on the market despite the fact that many intermediaries as of today lack, particularly within the MLM and pool structures, the baccalaureate.

Per IA, the expertise requirements are met either by having a secondary or tertiary degree in insurance-related program or by passing a professional exam.<sup>143</sup> I cannot back it by any data, though I assume that most of the registered intermediaries had to pass the

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<sup>136</sup> Article 18/1 of IA Article 55/1 of IDA.

<sup>137</sup> Article 18/1 of IA, Article 56/1 of IDA.

<sup>138</sup> Article 18/2 of IA.

<sup>139</sup> Article 56/2 of IDA.

<sup>140</sup> Article 56/5 of IDA.

<sup>141</sup> See Table 10. Hierarchy of insurance distributors under IDA.

<sup>142</sup> Article 123/2 of IDA.

<sup>143</sup> Article 18/2 of IA.

professional exam. Under IDA, the secondary or tertiary degree in insurance-related program is no longer an alternative to the professional exam.<sup>144</sup> Thus, the professional exam as a bar to the profession is no novelty, its structure and content is.

IA distinguishes between three levels of the professional exam: basic (applicable to *tied agents, subordinated agents* and *exclusive agents*); medium (applicable to *independent agents*); advanced (applicable to *brokers*).<sup>145</sup> The decree<sup>146</sup> then sets out the general conditions of organizing the exams and in its annexes (3-5) delineate the requirements for each level in a manner which encompasses all insurance product lines. CNB releases sets of questions for each level that the prospective applicants need to make themselves familiar with.<sup>147</sup>

In line with the rest of IDA, not only registered intermediaries but all distributors of insurance<sup>148</sup> are obliged to pass the professional exam<sup>149</sup>. The level structure is abandoned and instead insurance product line approach is embraced. That is, the content of the exam is based on five different insurance segments: a) life insurance; b) non-life insurance with exception of d) and e); c) MTPL and CASCO; d) business insurance with the exception of e); e) large risks and reinsurance.<sup>150</sup> The applicant's exam contains only questions relevant to those insurance segments that he or she wishes to distribute (the license will be only valid to those segments). That is, the typical current *subordinated agent* in OVB would only pass letter a) and b) segments. Also, under IDA, only accredited persons will be allowed to hold the exam.<sup>151</sup>

The transition, similarly as was the case of the general knowledge requirements, will not be so dramatic as it might appear at the first sight. In the period of the first year after the

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<sup>144</sup> Article 56/3 of IDA.

<sup>145</sup> Article 5/4 of IA, Article 6/3 of IA, Article 6a/3 of IA, Article 7/3 of IA, Article 8/3 of IA.

<sup>146</sup> Decree No. 582/2004 Coll. on Implementing Certain Provisions of the Act on Insurance Intermediaries and on Independent Loss Adjusters.

<sup>147</sup> See CNB.cz [online], 2018 [cit. 2018-02-25]. Professional exams. Available at WWW: <[https://www.cnb.cz/cs/dohled\\_financi\\_trh/vykon\\_dohledu/povolovaci\\_schvalovaci\\_rizeni/poj\\_zprostredkovatele\\_likvidatori/zkousky\\_odborne\\_zpusobilosti.html](https://www.cnb.cz/cs/dohled_financi_trh/vykon_dohledu/povolovaci_schvalovaci_rizeni/poj_zprostredkovatele_likvidatori/zkousky_odborne_zpusobilosti.html)>.

<sup>148</sup> See Table 7. Hierarchy of insurance distributors under IDA.

<sup>149</sup> Article 55/1 of IDA.

<sup>150</sup> Article 57/1 of IDA.

<sup>151</sup> Article 61 of IDA.

roll out date<sup>152</sup>, the former IA's intermediaries will be allowed to rely on their pre-IDA professional exams. The employees, that is distributors who lack the professional exams under IA, will have recourse to a declaration on honour that they possess the necessary expertise requirements.<sup>153</sup>

To conclude, one year after the roll out date all the distributors of insurance, that is some ~30-40ths people<sup>154</sup>, will have to pass the new professional exams. I expect that these active distributors will not have a hard time passing the exams, particularly in light of the product line approach of the new exams. Also, under IDA all the distributors of insurance are obliged to strengthen their professional competence by continuing training and development in the duration of at least 15 hours annually.

The second prerequisite of a successful registration, along with professional competence, is the requirement of trustworthiness. Per IA<sup>155</sup>, the applicant passes (grossly simplifying) the requirement of trustworthiness, if he or she has legal capacity, has not been convicted of certain offences and no insolvency decision concerning the applicant's property has been made in the past five years.

IDA is much much more laconic regarding trustworthiness. It merely states<sup>156</sup> that requirement of trustworthiness is satisfied, if the applicant has legal capacity and his or her personality, in the case of natural persons, or its conduct hitherto, in the case of legal persons, give supposition of the proper code of conduct according to the act. And, of course, it extends the requirement to all the distributors of insurance in line with the whole intention of the act. In the explanatory memorandum the legislator explains that the relevant article is to be conceived in a broader and stricter sense than the IA's rules. It explains that the trustworthiness will be assessed in line with the CNB's Official

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<sup>152</sup> Current Article 123/1 of IDA stipulates that the grace period ends on the 23<sup>rd</sup> of February 2019, however, that is because at the time the proposal was written, it was expected that it will come into effect on the 23<sup>rd</sup> of February 2018. Therefore, I assume that the revised wording will stick to the one year period and only change the relevant date.

<sup>153</sup> The explanatory memorandum explains this exemption by referring to the fact that after the roll out date there will be a shortage of accredited persons who would be allowed to organize the professional exams.

<sup>154</sup> That is active registered intermediaries calculated in chapter 3.1.3 + employees of insurance undertakings, banks, brokers, etc.

<sup>155</sup> Article 19 and Article 20 of IA.

<sup>156</sup> Article 70 of IDA.

Information of 3<sup>rd</sup> December 2013 regarding the interpretation of the terms trustworthiness and competence and acts dealing with a similar subject matter such as the Act No. 257/2016 Coll., on Consumer Credit.

### **Information Requirements and Code of Conduct Rules**

The Intermediaries Act deals with information requirements and code of conduct rules in five articles 21 – 21d. Article 21 stipulates, inter alia, that, the intermediary has to act with due professional care, protect consumer interests, is forbidden from putting forward misleading, false, incomplete or ambiguous information, and further is bound by the duty of confidentiality. Regarding the disclosure of information, the intermediary is obliged to, apart from the general personal data, inform the prospective policy holder (upon his or her inquiry) about the nature of his or her remuneration. This is a fundamental obligation that would have allowed the prospective policy holder to grasp the substance of the policy he or she is about to consent to, had the provision worked as it should have had. That is to say, the intermediary satisfies the legal obligation if he or she discloses the nature of his or her remuneration and not its size and calculation method. It is reasonable to make the assumption that many policy holders would not have had consented to their unit-linked policies had their known that the premium they are paying is not invested at all during the first two years and instead it goes to the intermediary as a commission<sup>157</sup>. Further, the intermediary is obliged to disclose the nature of his or her principal – agent relationship. Lastly, the Article rules out the insurance of large risks and reinsurance from its scope<sup>158</sup>.

Article 21a deals with the information that need to be communicated prior to the conclusion of the policy. It includes the information regarding the insurance undertaking with whom the prospective policy holder is about to contract, the nature of the policy (length, premium, termination, etc.). Also it includes specific provisions for distance contracts and specific provisions regarding unit-linked insurance. For the latter, the intermediary is obliged to inform the customer about the risk of the investment, about the

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<sup>157</sup> See chapter 3.1.1 where it is stated that the average commission amounts to ~200% of the first year premium in the case of unit-linked insurance.

<sup>158</sup> There is little need for the consumer protection in these cases as there is no information asymmetry and parties act in the course of their business and not as individual consumers.

non-existence of the guarantees on return on investment and if there are guarantees then what is their extent and type.

The IDA steps up and extends the information requirements and code of conduct rules greatly as there are twenty-two articles relevant to the subject matter in comparison to IA's mere five articles. It obliges the distributors to act with due professional care<sup>159</sup>, which is interpreted as *de lege artis* in light of Article 5 of the New Civil Code.<sup>160</sup> The distributor has to make clear in which position he or she acts with the customer<sup>161</sup> and he or she has to act, among others, in accordance with the best interests of a customer<sup>162</sup>. Concerning the former obligation, I deem it as an apt remedy to the uncertain situation under IA, when one could not distinguish between various roles in which an intermediary approached the customer. The latter obligation raised concerns<sup>163</sup> within the insurance industry already when it appeared in the text of IDD. The explanatory memorandum to IDA understands best interests as an objective category and adds that the proposed policy has to be in line with the needs and demands of the customer.

The general rules of communication preclude the distributor from putting forward misleading, false, incomplete or ambiguous information and is bound by the duty of confidentiality.<sup>164</sup> Further pre-contractual obligatory information include, apart from the general personal data, specific information about unit-linked and endowment insurance where the distributor has to disclose, among others, the size of the surrender, incl. information about the expected development of the size of surrender in time<sup>165</sup>. Also, IDA rectifies the situation regarding the disclosure of the nature of distributor's remuneration. It requires to disclose: 1) if he or she is remunerated by a customer, an insurance undertaking or both; 2) the size of the remuneration paid by the customer himself; 3) the information about the nature of his remuneration in relation with concluded policy<sup>166</sup>.

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<sup>159</sup> Article 71 of IDA.

<sup>160</sup> Explanatory memorandum to the proposed Insurance distribution act, note to Article 71.

<sup>161</sup> Article 72/2 of IDA.

<sup>162</sup> Article 72/1 of IDA.

<sup>163</sup> See Opojisteni.cz [online]. 2017 [cit. 2018-03-19]. Does IDD define the best interests into the national law?. Available at WWW: <<http://www.opojisteni.cz/pojistny-trh/smernice-idd/definuje-smernice-idd-nejlepsi-zajmy-do-narodniho-prava/>>.

<sup>164</sup> Article 73 and 74 of IDA.

<sup>165</sup> Article 86, letter a) of IDA.

<sup>166</sup> Article 88/1, letter h), i), j) of IDA.

I consider this as a major development of the consumer protection in the field of unit-linked insurance, and as the key novelty in the area of distributors' obligations brought about by IDA.

## Conclusion

This thesis set out to provide the reader with an understanding of the current situation of insurance distribution under the Intermediaries Act and guide him or her through the transition to the market situation under the proposed Insurance Distribution Act. While I hold that the individual objectives of the thesis were achieved and, thereby, the aim that I committed myself to at the outset of this thesis was met, the depth, laboriousness and insightfulness of my analysis of each objective varied greatly. In the following paragraphs, I would like to revisit the main findings as they respectively unfolded in the thesis and bring the reader's attention to the issues, that I deem the most relevant, and offer my personal interpretations and beliefs pertinent to them.

In the first chapter, I segmented GWP into product lines to clarify what are the statistically relevant products that are distributed. On a general note, it is, in my view, unsatisfactory that one has to fall back on the CAP's data instead of the official source, that is CNB. The voluntary professional association clearly substitutes CNB's role. The problem is even more aggravated by the further detachment between the two due to the Solvency II reporting format. The figures itself are not only revealing with regards to the different classes of insurance, where the main finding was that only a handful of product lines make up of the majority of GWP, but also for their potency to contextualize the insurance industry as such. For instance, it was calculated that life insurance amounted to CZK ~44 bln. in 2016 and plateaued since 2010. In the context of household banking deposits reaching CZK ~2 367 bln. (CAGR ~5%)<sup>167</sup> or volume of assets in mutual funds amounting to CZK ~432 bln. (CAGR ~15%)<sup>168</sup> in the same time period, it is evident that the insurance industry is way less prominent within the domestic economy than one would have thought.

The second chapter, dedicated to conceiving a concept of distribution channels that would be the most faithful to the reality, is a cornerstone of the thesis as it structures our thinking about the distribution per se and thus gives shape to the following analysis of the two

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<sup>167</sup> Per CNB's ARAD database.

<sup>168</sup> Per statistics of the Association for Capital Markets in the Czech Republic, see Akatcr.cz [online]. 2017 [cit. 2018-02-17]. Statistics of the Association for Capital Markets. Available at WWW: <<https://www.akatcr.cz/index.do>>.

regulatory frameworks. It was essential to isolate the methods of communication and legal categories of intermediaries from the individual distribution channels, I believe that was the key observation. On the other hand, segmenting the external channel into independent and exclusive is the weakest part of the concept, ultimately I have decided to keep it like that for the reason that it illuminates the nature of the legal categories of intermediaries. Also, for the time constraints, I have regrettably gave up the idea of quantifying the share of each distribution channel despite the fact that I have deliberately conceived them in such a manner that enables quantification<sup>169</sup>.

The first part of the third chapter that deals with the applicable Intermediaries Act was by far the most labourious part. The five legal types of domestic intermediaries along with the multiplicity of registrations lack transparency and make it impossible to create any hierarchy within the intermediaries. Ultimately, the only way how to interweave the legal categories of intermediaries with the distribution channels was a meticulous and lengthy work with the CNB's registry supplemented by the market intelligence. However, it yield qualitative findings that were, in my view, astonishing and rendered the effectiveness of the regulation doubtful. Firstly, it was revealed that the dominant, in a sense of distributed GWP, *brokers* model operate on a basis that there is one legal person registered as a *broker* and it employes tens or hundreds of employees who pursue the actual intermediary business. These employees, similarly as the employees of insurance undertakings, fall outside of the ambit of the act, thus, for instance they do not have to pass any professional exams or observe the code of conduct stipulated by the act. The second failure of the act is the gross conflict of interests it allows to flourish. It was illustrated on the case of Renomia, a.s. which is registered as a *broker* and an *independent agent* with 20 insurance undertakings at the same time. It has *subordinated agents* registered with Renomia, a.s. as the *broker* and *subordinated agents* registered with Renomia, a.s. as the *independent agent* and these *subordinated agents* are the very same real persons. The distinguishing factor of the legal category of the *broker* and the *independent agent* is that his or her principal is the customer himself on whose behalf the *broker* acts. However, here the very same people represent the interests of the insurance undertakings and thus put the whole point of the legal category of the *broker* under the

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<sup>169</sup> It would require ~50 hours of data collection in excel and I have resigned to do that.

applicable act into question. It is concluded that the Intermediaries Act not only fails to accommodate most of the distribution channels but does so on a selective basis without providing any clear rationale for choosing one channel over the another.

The proposed Insurance Distribution Act rectifies most of the failures that I identified in the applicable regulation. It brings employees of both the insurance undertakings and intermediaries within the scope of the act and, thereby, it covers all the distribution channels. Further, it precludes multiple registrations and simplifies the intermediary types. It is submitted that as far as IDA's rules relating to the "target market" are concerned, they are both commendable and clear-cut. However, what is problematic and raises concerns is the transition from the current market to the IDA's "target market". The most notable issue is the one of re-registration of one real person as a tied intermediary by multiple principals which will lead to fierce competition or to outright moral hazard should my interpretation of the IDA's provisions in chapter 3.2.1 turn out to be substantiated.

The insurance undertakings are already not only preparing the most cost-efficient compliance with the regulatory requirements, but they are also drafting strategies how to make use of the opportunities presented in this transition. It will be very intriguing to observe the future market movements, once the new regulation comes into effect, and I hope that this thesis may help the reader to navigate this transition.

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## **English-Czech Terminology**

capital assurance / fixed-amount insurance – obnosové pojištění

claim – škoda

commission – provize

contractual insurance – smluvní pojištění

endowment life insurance – kapitálové životní pojištění

exclusive agent – výhradní pojišťovací agent

ex-lege workers' compensation – zákonné pojištění zaměstnanců

financial placements – finanční umístění

gross written premium – hrubé předepsané pojistné

guaranteed technical interest rate – garantovaná technická úroková míra

insurance agent – pojišťovací agent

insurance broker – pojišťovací makléř

insurance undertaking – pojišťovna

intermediary – zprostředkovatel

loss assurance – škodové pojištění

mandatory insurance – zákonné pojištění

motor hull insurance except rolling stock – havarijní pojištění

motor third party liability – pojištění odpovědnosti z provozu vozidla

obligatory contractual insurance – povinné smluvní pojištění

policy – pojistná smlouva

policy holder – pojištěný

premium – pojistné

regular paid premium – běžně placené pojistné

single paid premium – jednorázově placené pojistné

subordinated insurance intermediary – podřízený pojišťovací zprostředkovatel

supplementary insurance – doplňková pojištění

technical provisions – technické rezervy

term-life insurance – běžné životní pojištění

tied insurance intermediary – výhradní pojišťovací zprostředkovatel

underwriting – upisování

unit-linked insurance – investiční životní pojištění

value chain – hodnotový řetězec

voluntary contractual insurance – dobrovolné smluvní pojištění

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## **Resumé**

Tato diplomová práce se zabývá distribucí pojištění v České republice. Za cíl si klade seznámit čtenáře s jednotlivými distribučními kanály v kontextu současné a nastávající regulatorní úpravy. Metodologicky se práce opírá především o deskriptivní, analytický a empirický přístup k právnímu výzkumu. První kapitola, jež nese název Pojišťovací trh, představuje hrubé předepsané pojistné jakožto základní metriku v pojišťovnictví a provádí segmentaci předepsaného pojistného podle hlavních produktových linií. Dále obsahuje pojednání o zdrojích, jež jsou relevantní pro celou práci, a zasvěcuje čtenáře do používané terminologie. Druhá kapitola předkládá koncepci distribučních kanálů, skrze něž se prodávají pojišťovací produkty zákazníkům. Z pohledu pojišťovny se jednotlivé kanály dělí na vnitřní a vnější. Mimo schéma jednotlivých distribučních kanálů pak stojí zákonné kategorie zprostředkovatelů a způsoby interakce distributora pojištění se zákazníkem, neb ty nejsou výlučné vzhledem k žádnému konkrétnému kanálu, ale naopak se vyskytují napříč kanály. Diplomová práce byla vypracována v období, kdy se očekává přijetí nového zákona o distribuci pojištění, který nahradí stávající zákon o pojišťovacích zprostředkovatelích. To je reflektováno v třetí kapitole, jež se dělí na dvě podkapitoly, které obsahují analýzu distribučních kanálů v kontextu zmíněných dvou zákonů. První podkapitola obsahuje taxonomii a kvantifikaci právních kategorií zprostředkovatelů a pojednává o nich v kontextu jednotlivých distribučních kanálů z předchozí kapitoly. Druhá podkapitola pak ukazuje jak se změní distribuce pojištění ve světle nového zákona o distribuci pojištění. Mezi hlavní změny patří tzv. distribučně neutrální regulatorní přístup, díky němuž se regulace nově vztahuje na všechny distribuční kanály včetně zaměstnanců. Dále zjednodušené právní kategorie zprostředkovatelů a rozšířené a zostřené právní povinnosti pro zprostředkovatele.

## **Abstract**

This MA thesis is concerned with insurance distribution in the Czech Republic. It aims to acquaint the reader with individual distribution channels within the context of current and upcoming regulatory framework. Regarding methodology, it makes use of the descriptive, analytical and empirical approach to legal research. The first chapter, The Insurance Market, introduces the gross written premium as the key metric in the insurance industry and it segments the written premium into the main product lines. Further, it deals with sources that will be relied on throughout the thesis and presents the necessary terminology. The second chapter outlines the distribution channels framework through which the insurance products are sold to customers. From the perspective of an insurance undertaking the main distinction is on the internal and external channels. The legal categories of intermediaries and the methods of communication with the customer do not form any particular channel, instead they are understood as cross-channel. The MA thesis is submitted in the period when the applicable Intermediaries Act is about to be superseded by the forthcoming Insurance Distribution Act. That is reflected in the third chapter that is divided into two subchapters, each dedicated to the analysis of the distribution channels under the relevant acts. The first subchapter contains the classification and quantification of the legal categories of intermediaries and interweave them with the individual distribution channels as outlined in the previous chapter. The second subchapter examines the change in the insurance distribution in light of the new regulation. As a major novelty, essentially all the distribution channels fall under the ambit of the regulation, including employees. Also the categories of insurance intermediaries are simplified and their obligations are stepped up and extended.

**Klíčová slova**

Pojišťovací zprostředkovatelé; Zákon o distribuci pojištění; Zákon o pojišťovacích zprostředkovatelích

**Key words**

Insurance intermediaries; Insurance Distribution Act; Act on Insurance Intermediaries