



## **Recommendation No. 4/2008 (of December 4) of the Board of the Hungarian Financial Supervisory Authority**

### **On the prevention of abuses related to the activities of intermediaries, on the audit of intermediaries, on issues of money-management and documentation**

#### **I. The Purpose and Scope of this Recommendation**

1. **In addition to retaining the stability of the financial markets, compliance with the expectations set forth in this Recommendation also serves the fundamental interests of the customers of financial organisations, it is therefore reasonable for organisations to implement it in their activities.**
2. The criteria set forth in this Recommendation represent ideal practices that have neither legal force nor any mandatory substance.
3. **The purpose of this Recommendation** with regard to the activities of intermediaries is as follows:
  - To specify procedures consistent with the protection of the interests of customers on the onehand;
  - And to represent the prudent practices being used by certain financial organisations already active in the financial markets on the otherhand;
  - To prevent and deter unlawful conduct and to prevent abuses perpetrated by intermediaries.
4. **The following are the implementation expectations of this Recommendation:**
  - To enforce the requirement for prudent operation;
  - To facilitate compliance with statutory provisions;
  - To reduce operational, reputational and legal risks;
  - To promote stability, calculability and fair competition;
  - To mitigate abuses perpetrated by intermediaries;
  - To enforce the interests of customers as set forth in contracts, to help avoid future legal disputes.
  - To provide appropriate protection for customers and for proprietary interests.
5. **This Recommendation is addressed to financial organisations that are** entitled to operate as credit institutions or as insurance companies or to engage in directly related activities pursuant to the legal regulations in effect in the territory of Hungary, i.e.,:
  - Financial institutions:
    - Banks;
    - Specialised credit institutions;

- Co-operative credit institutions;
- Financial enterprises.
- Insurance companies:
  - Insurance corporations;
  - Insurance co-operatives;
  - Insurance associations.

The expectations set forth in this Recommendation may be construed and implemented also in relation to the intermediation of services on the capital markets, as well as in relation to the intermediation of the services of private and voluntary pension funds and of mutual and health insurance funds.

6. **The definitive norms for the contents of this Recommendation are as follows:**

- The rules related to the intermediation of financial services as set forth in Act CXII of 1996 on credit institutions and financial enterprises (the Credit Market Act: CMA);
- The rules for insurance brokerage activities as set forth in Act LX of 2003 on insurance companies and insurance activities (the Insurance Act: IA);
- Act C of 2000 on Accounting;
- Act CXXXVI of 2007 on the prevention and deterrence of money laundering and terrorist financing (the Money Laundering Act: MLA);
- The recommendation issued by the IAIS in October 2006 with the title: “Guidance paper on preventing, detecting and remedying fraud in insurance”.

7. For the purposes of this recommendation the **intermediation of financial services (activity as an agent)** shall mean an activity performed in the name, for the benefit, at the liability and at the risk of a financial organisation with the aim to perform the activities of the financial organisation in the provision of financial services and supplementary financial services in the framework of a contract for commission. Agents performing such activities are termed as “Type A” agents with reference to the term used in the corresponding section of the CMA. The HFSA is aware of the discussions for the proposed Bill for the amendment of the CMA, on-going at the time of issue of this Recommendation, which if passed by Parliament shall define financial intermediaries as dependent agents, independent agents and financial institutions as specified in legal statutes. Should the mentioned legal statute be passed, the scope of this Recommendation shall also extend to the listed financial intermediaries and especially to dependent agents.

For the purposes of this Recommendation **insurance brokerage activities** shall mean regular business activities aimed at the creation of insurance contracts. This activity shall include the facilitation of the conclusion of insurance contracts, the presentation and recommending of insurance products, the related furnishing of information and the conclusion of insurance contracts, the organisation of the sales of insurance contracts and co-operation in the transaction and fulfilment of insurance contracts.

For the purposes of this Recommendation a **dependent insurance broker** intermediates the insurance products of a single insurance company or the insurance products of several insurance companies that are not in competition with each other. Dependent insurance brokers shall also include insurance brokers that perform intermediation as a

supplementary activity for products or services connected with their primary activities, provided that they do not collect insurance premiums from customers or sums due to customers from insurance companies. Dependent insurance brokers intermediate insurance contracts in the framework of their employment with the insurance company or on commission by the insurance company.

When using the term “intermediation activities” this Recommendation means the above **three** activities jointly, with certain rules also construed and applicable to independent insurance brokers, with special consideration to independent insurance brokers that have networks of agents with large headcounts.

8. **For the purposes of this Recommendation** customer **shall mean** a contracting party, an insured party, a beneficiary, someone that has suffered damages, or any other person entitled to the services of the insurance company, while in the application of data protection provisions customer shall also mean a person who makes a contractual offer to the insurance company.

In setting forth the principles and recommendations this document does not intend to refer back to statutory provisions. Therefore, if legal statutes contain regulations that point beyond the principles and recommendations, the HFSA will of course consider compliance with those as fundamental.

The HFSA has previously issued its Methodology Guideline No. 1/2002 on the audit of the activities of agents used as intermediaries of services provided by financial organisations and on the management of risks. Within the framework of this Recommendation we now reinforce, and provide specific implementation requirements to expand the expectations set forth in Sections II/5-11, II/14-17 and III/2 of Methodology Guideline No. 1/2002. Further publications of a universal nature with more comprehensive detail include the following:

- Recommendation No. 15/2001 issued by the Chairman of the HFSA on the information to be provided to customers by financial organisations;
- Recommendation No. 9/2006 (of November 7) issued by the Supervisory Council of the HFSA on the principles for preliminary information to customers for retail lending;
- Recommendation No. 11/2006 (of December 14) issued by the Supervisory Council of the HFSA on the development and operation of internal lines of defence;
- Methodology guideline No. 2/2006 of the HFSA on the assessment of life insurance requirements and on product brochures.
- Recommendation No. 3/2008 (of November 20) of the Supervisory Council of the HFSA on the prevention and deterrence of money laundering and terrorist financing.

## **II. Issues related to offers and printed contractual documents**

1. In order to avoid and to efficiently prevent abuses, insurance companies should manage their printed offer documents for life insurance and their printed documents that entitle to cash receipts, and financial institutions should manage their printed contractual documents (all of the above hereinafter referred to as printed forms) in a form that

provides for unique sequence numbering (identifiers) and allows for the monitoring and verification of their use on a daily basis consistently with the various records.

### **III. Money-Management**

2. In line with best practices established on the financial markets, intermediaries (except for credit institutions engaged in dependant intermediary activities) may not receive cash directly from customers, which allows for the avoidance of customer complaints related to this and simplifies compliance with the rules for the prevention of money laundering. There may be a concern in the case of the insurance industry that customers may fail to pay the first premium following an offer being made and this may result in a high cancellation rate for the specific financial organisation. Based on the data processed in the course of the activities of the supervisor it was found that this concern was not reflected in the cancellation rates, i.e., financial organisations whose intermediaries are not allowed to receive either first or subsequent premium payments have better than average (lower) cancellation rates.
3. If pursuant to the decision of a financial organisation its intermediaries are allowed to receive cash, then the financial organisation should clearly regulate the maximum amount and the conditions for its transfer to the financial organisation and should inform its customers accordingly. It should inform its customers in a conspicuous place and form within the text of its printed forms whether or not its intermediaries are entitled to receive cash. If its intermediaries are entitled to receive cash, the maximum value should also be shown.
4. With consideration to the high amount of the ad-hoc fees used for certain types of transactions (such as for unit-linked life insurance), it is of particular importance to implement strict rules for the possibility of cash receipts, and all related procedural mechanisms should be presented to customers (in particular, but not limited to, separate declarations, means of payment and the forms of payment confirmation).

### **IV. Issues related to the legal status of intermediaries and the audit of the activities of intermediaries**

5. The independent internal audit activities of financial organisations should extend to business processes and to legal relationships related to its agents.
6. In the experience of the HFSA there is a lack of consistency between the internal regulations of certain financial organisations with regard to their intermediaries, and their practices and contracts used. A typical error to be mentioned is the lack of accurate regulations for liability issues in contracts (for commission) and that liabilities for damages caused in the course of the activities of the intermediary are not specified correctly. In numerous cases the provisions related to the receipt of premiums are not clear and sometimes contradictory to the internal regulations. Financial organisations should pay special attention to avoid the above errors and should regularly review the consistency of their internal regulations with their contracts for intermediary activities and their practices.
7. Experience shows that financial organisations do not proceed with prudence when selecting their intermediaries and when performing due diligence on those (in particular to verify the existence of official certificates of no criminal record and to apply minimum qualification requirements even where those are not explicitly required by legal statutes).

Organisations place less emphasis on auditing the activities of their intermediaries that have several years of experience and audit those less frequently and exercise less management control (preventive activities) within their business processes of the contracts concluded by those or of the offers given to those, without fully enforcing the four eyes principle. When emphasising the role of management control and process-integrated control activities it is important to accentuate that preventive measures should not depend on the practice obtained by the intermediary, i.e., preventive measures should be performed to the same depth and breadth for all individual intermediaries and a written document should always be made when they are performed. For financial organisations the information obtained in the course of preventive measures is also necessary to develop the customer profiles (in connection with the prevention of money laundering).

8. All intermediaries can be expected to perform weekly professional management control over cash receipt documents subject to strict tracking requirements for all of their intermediaries using a risk-based approach. Prudently operating financial organisations should develop an efficient system of incentives to prevent omissions related to cash receipt documents subject to strict tracking requirements and related to the timely settlement and payment of the funds received therewith, to incentivise their intermediaries to comply with the rules. It is recommended to specify the shortest possible deadline for settlement as reasonable under the business framework.
9. The number of printed forms that intermediaries may keep should conform to the extent and composition of their activities performed. Financial organisations should continuously monitor and compare the amount and composition of their printed forms in the possession of their intermediaries to the intermediary activities performed by those.
10. If intermediaries employ seal impressions in the course of their intermediary activities, they are expected to use seals that make impressions that are suitable for unique identification. Financial organisations are required to maintain up-to-date records of their seals and of the impressions and users of those.
11. Financial organisations shall efficiently and promptly inform their customers also using their IT solutions (such as their internet home pages), if any seals or unused documents subject to strict tracking requirements get stolen or lost, or if they land outside their circle of entitlement in any way, and about any abuses committed with those.
12. Financial organisations should specify in advance the minimum performance requirements which, if not met, the legal relationship with the intermediary will be terminated. Agents included in the supervisory records with an inactive status may weaken the trust of the public in the adequacy of the records and may also create opportunities for abuse.
13. The procedure to be followed upon the termination of a legal relationship for intermediation should be contained in the internal regulations and in the contract concluded with the intermediary, and should address in detail the process and the steps of final settlement with the intermediary and in particular how the intermediary should account for printed forms subject to strict tracking requirements, for vouchers and seals, and should address the deadline for the settlement. Such vouchers and assets should not remain with the intermediary following the termination of a legal relationship.
14. Financial organisations should not allow their contracted intermediary corporations the opportunity to use deceptive names (except for cases where the principal financial organisation has ownership stakes or controlling powers in the intermediary corporations). Use of a deceptive name includes the use of a name containing the name of

the financial organisation, or a name which is slightly different but similar in sounding. The use of such names could create a deceptive image in the minds of customers with regard to the activities of the intermediaries and with regard to the extent of their representation.

15. Financial organisations should refrain from paying advances on commissions or from advancing commissions to their intermediaries and should strive to pay commissions on fees already collected, and should regularly assess the activities and the performance of their agents and the quality of the portfolios intermediated by those. Financial organisations should maintain records of transactions to also enable a clear identification of the intermediary. In order to improve the quality of transactions financial organisations in all involved sectors should develop commission clawback practices that already function in insurance.

## **V. Fighting abuses perpetrated by intermediaries**

16. Financial organisations should have units (such as the compliance function) that perform regular checks to fight abuses perpetrated by intermediaries. Financial organisations should develop internal organisational structures that enable the transfer of substantive information obtained in such checks carried out, to the appropriate persons or divisions.
17. If financial organisations detect irregularities or abuses in the course of the activities of their intermediaries that endanger the prudent and transparent functioning of the financial market, the HFSA deems it necessary that they take the required measures without delay towards the authorities with the appropriate jurisdiction and competency. Upon a violation of the substantive rules of the penal code, financial organisations should also take steps to initiate, without deliberation, penal proceedings without regard to any partial or complete remedy of any damages that may have been incurred. The standard is to make reports in the written form.
18. In the experience of the HFSA authorities usually obtain limited information on financial abuses and thus there is no data available from individual specific financial service providers relevant for the assessment of operational risk. In order to fight and prevent financial abuses, to obtain a complex understanding of external and internal abuses, to discover new types of unlawful conduct and to develop a prevention methodology, financial organisations should report information on unlawful attacks suffered by them (incidents) not only to the crime-fighting organisations, but also to the HFSA by providing regular quarterly data on statistics and by making immediate reports on emphasised incident events that pose operational risks.
19. In line with the best practices established on the international financial markets, financial organisations should prepare separate regulations in order to discover, to deter and to prevent abuses. It is justified for the regulations to elaborate, among others, the responsibilities of the staff engaged in fighting unlawful activities and the checks and balances and procedural rules integrated into the process for the screening and the management of abuses.
20. It is justified to use internal control and screening systems employed by financial organisations not only to deter business relationships and transaction orders that enable money laundering and terrorist financing, but also to screen for other abuses. The statistics thus collected will facilitate the assessment of trends on the financial markets on

the one part, and will contribute to the transformation and improvement of internal regulations on the other part.

21. For the sake of best practices the training employed by financial organisation on the prevention and deterrence of money laundering and terrorist financing, where this has not yet taken place, should be supplemented with special training on the discovery and fighting of abuses.

## **VI. Data entry into the records on intermediaries maintained by the HFSA**

22. In relation to the up-to-date status of the records maintained by the HFSA and to the veracity of the data contained therein, financial organisations are expected to reinforce and develop process-integrated checks and management checks within their data entry and data transmission functions. These checks should also extend to data quality, to successful data transmission, and to observing the statutory deadlines. Such checks are to be developed even if data is prepared and transmitted using information technology systems. Financial organisations should maintain up-to-date records even if there is no statutory obligation and should enable their customers to simply acquaint themselves with data that carries substantive information content for the public.
23. The independent internal audit organisations (internal auditor) of financial organisations should regularly examine and document the efficient functioning of process-integrated and management check-points and should inform their Supervisory Boards and the management of their financial organisations of their findings, and should inform the HFSA if there are deficiencies that pose systemic risks or if there are other highly severe deficiencies.

## **VII. Information to customers, cooperation, certain issues of the existing legal relationship, training**

24. Financial organisations should inform their customers in a pre-determined form of each case of receipt of certain ad-hoc extraordinary incoming payments as specified in the contracts and regulations.
25. It is a fundamental requirement for all written documents presenting the actual status of a customer's account (balance, turnover, incoming and outgoing payments, etc.) to be sent by the financial organisation directly to the customer and to avoid any role to be taken by intermediaries in forwarding those. It is an incorrect practice that may provide opportunities for abuse, for an intermediary to be entitled to forward such information materials to the customer.
26. Financial organisations should register ad-hoc payments related to a contract or offer on a single account number or policy number. It is an incorrect practice to use several account numbers or several policy numbers to record several incoming payments within the framework of a single legal relationship.
27. Financial organisations should clearly regulate on the contractual level for all possible economic events in connection with the customer's contract, what may be considered as delivery, also addressing the place, deadline and means of delivery.
28. Financial organisations should prominently accentuate the efficient training of their intermediaries (even if statutory provisions do not prescribe mandatory training or an

obligation to pass an examination) and should confirm in the course of training whether or not their intermediaries possess appropriate in-depth knowledge in their fields of specialty.

29. If an intermediary intermediates the comparable products of several financial organisations it should provide its customers the possibility of choice and decision even if such an obligation is not specifically formulated in the legal statutes governing the specific financial sector. Intermediaries should inform their principals of their commission amounts related to the intermediated transactions.

### **Closing Provisions**

30. This Recommendation is a legal instrument issued pursuant to Section d) of Paragraph (1) of Article 12 of Act CXXXV of 2007 on the supervision of financial organisations by the state. The substance of this Recommendation issued by the Supervisory Council expresses the requirements set forth in legal statutes, the principles and methods recommended for implementation on the basis of the law enforcement practice of the HFSA, as well as market standards and usual practices.