
The Role of a Broker in an Open Insurance Market Place

A Paper presented by

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Mr Chairman, distinguished ladies and gentlemen.

The title of my paper today is “The Role of an Insurance Broker in an Open Insurance Market Place”, and I intend to treat this topic under the following distinct headings:

- Historical Developments
- Definition of an Insurance Broker
- The Broker’s Role
- The Role of the Broker in Developing Countries
- Advantages versus Disadvantages of a Broker-led Market
- Challenges facing the Insurance Broker

The contents of my paper, which are equally applicable to reinsurance brokers, are a result of my personal observations and experience as a practising Insurance and Reinsurance Broker, both in the developing countries as well as in the London and international market place, over the past decades.

1. HISTORICAL DEVELOPMENTS

In the early development of insurance, underwriters and insurance companies could not afford to set up their own branch offices in every community to develop business and so they had to rely on agents. Most agents often had other business undertakings and would generally only act for a limited number of insurance companies, and often only one, on a part time basis. This pattern was

true in the UK, the USA and the continent of Europe. It was duplicated overseas as these insurance companies developed internationally.

It is said that the broker originated in marine insurance. Shipowners tended to use their own agents to purchase insurance, and their agents owed their primary loyalty to the shipowner rather than to the insurance company. This development of the broker as an agent of the client was also encouraged by the organisation of the Lloyd's market, where competing underwriters could not appoint a network of agents and had to rely on brokers bringing them business. There is no doubt that the agency system of distribution is losing some market share for the insurance companies because of the active involvement of brokers who have already obtained the great majority of industrial and commercial business in the UK, USA and increasingly in continental Europe.

Consider the personal lines sector of Direct Line in the UK. It is a combination of speedy and efficient distribution and of sophisticated technology – based pricing that makes Direct Line work. In return for that customers accept a very limited level of discretion, both in price and service. Increasingly these characteristics will be the transactional side of the other form of insurance business. In effect, insurers are “stealing” the brokers traditional stamping ground – distribution. This is not a new phenomenon, but pressure on profits and contemporary technology are accelerating the process. The historical providers seek to distribute their products directly to the end – customer, thereby extending their activities from underwriting to marketing and distribution.

The initial response of the intermediaries to such vertical integration was to extend their traditional marketing and distribution role into underwriting. There were mixed results.

Consequently, the lesson to be learnt is that distribution itself is no longer a value added service, it has become another transactional activity that must be carried

out quickly, efficiently and economically by those who will be the insurers. It is the common ground between capacity providers and the service providers.

In Sweden, for example, where brokers were licensed relatively recently, companies such as the Skandia, who had perhaps 50% of the industrial and commercial business direct, are now facing much stiffer competition as brokers introduce competition in the market.

There will always be some insurance companies such as some Mutuals, or new arrivals like the Direct Line, who deal direct with the insured without the involvement of any agent or broker. They will tend to be in specialist classes where there is a defined number of clients, or where the provision of specialist services (such as Engineering) is perhaps as important as the insurance policy itself.

2. DEFINITION OF AN INSURANCE BROKER

Prior to discussing the role of an insurance broker, it is useful to remind ourselves of the definition of an insurance broker.

An interesting definition of “brokers” is set out in Article 2(1)(a) of the EEC Directive on insurance agents and brokers in December 1976:-

“Persons who, acting with complete freedom as to their choice of undertaking, bring together, with a view to the insurance or reinsurance of risks, persons seeking insurance or reinsurance and insurance and reinsurance undertakings, carry out work preparatory to the conclusion of contracts of insurance, or reinsurance, and, where appropriate, assist in the administration and performance of such contracts, in particular in the event of a claim”.

3. THE BROKER'S ROLE

As a general rule all insurers are sellers of insurance. They employ the services of insurance “producers” to market insurance. These producers are: tied agents, accountants, solicitors, insurance consultants and brokers.

On the other hand, an insured or a policyholder can often be placed in the position of selling his risk to Insurers. Take the example of an industrial or commercial enterprise wishing to purchase cover for a complex risk in a monopoly or restricted insurance market offering limited capacity; or a prospective Insurance buyer with an unacceptable loss record trying to obtain cover at affordable rates of premium. Such individuals and businesses employ insurance brokers to make the sale.

Unlike other insurance producers who are tied to insurers by agency contracts or by employer-employee relationships, brokers are free-lance operators who are duty bound to seek the best coverage possible for their clients. The broker's remuneration is, however, paid by insurers in the form of commissions or brokerage, instead of fees by the buyers.

Some brokers depend on the insurers to provide any after-sales service. However, in recent years there has been a marked increase in the tendency to place heavy reliance on the policy preparation and loss-prevention services offered through brokers' technical staff.

Large industrial concerns with complex risks often employ full-time insurance or risk managers who study their companies' loss exposures and insurance problems. They usually deal with brokers to minimise their corporate insurance costs by saving the agents' commission or by buying reinsurance for their own captive insurers rather than direct insurance.

This development is mainly due to the fact that a very important source of capacity is provided by Underwriters at Lloyd's of London who cannot be approached without the intermediary of an accredited Lloyd's Broker unless the Umbrella Arrangement is used. The ever-increasing values and complexity of risks has also brought about a sharp rise in the demand for the highly specialised technical knowledge and experience offered by brokers.

Brokers' close relationships with world-wide insurance and reinsurance markets has earned them the enviable reputation for being able to secure optimum terms to mobilise sufficient capacity and to satisfy the requirements of their clients.

Brokers are no longer regarded as middlemen who simply bring the buyers and sellers of insurance/reinsurance together and collect commission. Their main functions are now recognised to be the acquisition of business, its placement and subsequent servicing.

How does a broker carry out these functions – what are the advantages of using a broker instead of any other producer, or even dealing with an insurer/reinsurer?

Acquisition

During this stage the broker must acquaint himself with all aspects of the risk he is expected to place. He must gain first-hand knowledge of the account as well as familiarising himself with the peculiarities of his client's business. It is his responsibility to advise his client on how best to improve a risk in order to effect a saving in his insurance costs.

By frequent visits and constant contact with his client the broker will elicit and update the information required to make his presentation to the insurers who may wish to take a share in the business offered. This, in turn, can only be achieved by the broker maintaining close relations with the numerous insurers/reinsurers in his market and internationally.

Placement

The ability of a broker to negotiate and place business is dictated largely by where the broker is domiciled. If the insurance market in the place of his domicile does not offer capacity for large complex and hard-to-place risks, then the broker's function of placement of the business at optimum terms will be greatly impaired. In such instances, a broker needs to have access to the international insurance or reinsurance market, either through a network of correspondent brokers or through direct contact with insurers.

In the placement of his client's business a broker has the benefit of freedom to use any insurer of his choice. This freedom enables him to stir up competition among the insurers to negotiate his terms. The benefit of this system goes to the client, although the broker's remuneration is paid by the insurer/reinsurer with whom he places his client's business.

Servicing

This side of the broker's function is not generally appreciated until a contract of insurance becomes the subject of a major claim. In the course of his duties the broker has to provide a complete claims service, from the negotiating stage through to collection of losses from all participating insurers. Another important aspect of a broker's service is the drafting of specialist policy wording for the insurer and obtaining clients' agreement to the wording before the insurer signs the contract. In this way the broker endeavours to ensure better understanding of the terms of the insurance contract by both parties prior to the occurrence of an insured loss.

The broker also has to ensure collection of the relevant premium from the insured and its prompt remittance to all the insurers on a particular insurance policy, before receiving his own commission or remuneration.

The brokers' role in the future and the "value added services"

Historically the insurance broker had three principal tasks – market finder, price negotiator and transaction processor. But under the influence of underwriting consolidation and new technology, the role as market finder and negotiator is being eroded. Moreover, in addition to the provision of quality products and quality service which have assured the success of insurance brokers in the past, the provision of value added services is crucial to continuing success.

The promotion of risk management expertise, programme planning and analysis, local and regional knowledge and expertise, together with impartial advice are these value-added services.

Under the pressure of greater demands from clients and underwriters alike, brokers must re-define their function in understanding clients' needs and advising impartially but expertly on risk in its broadest sense. The role in this context is to identify risk, remove it where possible, manage what cannot be removed and arrange for risk transfer where necessary. This new role requires a broader skill base both globally and in the necessary service disciplines. The investment required threatens the viability of some brokers. Even for the larger firms of brokers this investment puts a pressure on costs unlikely to be remunerated by extra fees or commission.

There are numerous other pressures on insurance brokers. The consolidation of suppliers, insurers and reinsurers results in the customer's perception that the value of the intermediary is reduced. The influence of suppliers becomes greater as they themselves encourage customers to consider dealing with them direct. The expenses of the transaction are enormous and growing, despite the investment that intermediaries and insurers are putting into technology to enhance the process. The problem is that information technology solutions are being built around the existing functions.

The benefits of technology can only be exploited fully by eliminating unnecessary duplication, re-entry and checking. This requires acceptance within the broker/underwriter chain that there are functions, historically carried out by both, which in the future must only be done once, or not at all.

In a report completed in October 1995, it was stated:

“Networking remains in its infancy. Held back by the obstinate clinging of the insurance industry to its much loved but archaic processes, with a worship of being different for the sake of it. Indeed substantial numbers of executives believe that substantial progress towards simplification, standardisation and transparency threaten their very existence.”

It must be appreciated that understanding a customer’s requirements is the key to delivering quality service at a sustainable profit. The customer who understands and thus values the service he is getting is prepared to pay a fair price for it, including a profit for the provider. Any marketing professional would confirm that selling the wrong product at whatever the price is a short cut to disaster.

Thus a smaller enterprise may not be prepared to pay substantial fees for value added services whose potential benefits may not justify the expense in relation to the size of the business.

4. BROKERS IN THE UNITED KINGDOM

In the UK insurance brokers are subject to the provisions of the Insurance Brokers’ (Registration) Act 1977. This Act requires brokers’ compliance in matters of registration, professional conduct and compulsory professional indemnity insurance.

Background to The Insurance Brokers (Registration) Act 1997

Before 1981 any person or business, giving insurance advice to the insuring public could be set up without any academic qualifications, or practical experience. Such person or business could use any title such as “insurance broker”, “insurance adviser”, “insurance consultant”, or “insurance agent”, to name a few.

The 1970’s started badly with the demise of the Vehicle & General in 1971. The United Kingdom government was determined to eliminate future problems, and so a number of statutes were inaugurated, amongst which are the Insurance Brokers (Registration) Act 1977 and the Policyholders Protection Act 1975.

Such statutes as these signify radical changes in regulatory legislation in the last 30 years. The movement has been away from attempts to ensure the financial well being of insurance companies, to the protection of the individual customer. This is consistent with the age of consumerism within which we currently dwell.

And so the Insurance Brokers (Registration) Act 1977 came into force in 1981 because of a general realisation that one of the primary reasons for the failure of insurance companies was to some extent due to the role played by insurance intermediaries. Prior to this Act, and later the Financial Services Act 1986, insurance intermediaries were commission orientated, whereas they should of course be consumer orientated.

Consequently the dominating entity of high commissions or brokerage caused many intermediaries to act unprofessionally, selecting insurers not on the basis of the overall quality of their products, but on the commissions, including volume overrides, which were on offer.

This situation resulted in brokers organisations in existence in the late 1960’s approaching the Department of Trade and Industry with a framework for

legislation, which, it was hoped, would deal satisfactorily with the difficulties which were then prevalent. The Insurance Brokers (Registration) Act 1977 followed.

The main features of this Act:

- It gave a special unique meaning for the term “insurance broker” because thereafter the fuller phrase “registered insurance broker” referred to someone who could meet the qualification requirements of the Act, and who were prepared to conform to the other regulatory demands of the legislation.
- Prior to being authorised to be a registered insurance broker that person had to be entered into the apposite register.
- The Insurance Brokers Registration Council came into existence to enforce the Act of 1977, and is now being abolished from the end of October 1998 on the grounds that the broking market is sufficiently mature to regulate itself
- The Code of Conduct for registered insurance brokers was defined.
- The Council were given disciplinary powers.
- Accounting and other rules for the conduct of business were confirmed.
- It became essential for brokers to have professional indemnity insurance of at least £250,000 or three times their brokerage, whichever is higher, and subject to a minimum limit of £5,000,000. The maximum insurance cover required is £7,500,000.
- Adherence to the Grants Scheme. This is a fund administered by the Council whose aim is to compensate those who have suffered financially at the hands of incompetent brokers. It is paid for by a levy on all brokers. The claimant first proceeds against the accused broker and then uses the Scheme if unsuccessful against that broker.

Whilst this Act also applies in principle to Lloyd’s Brokers they enjoy a special status due to the self-regulation measures taken by Lloyd’s in recent years. These are embodied in The Lloyd’s Act 1982 and Lloyd’s Brokers Byelaws 1988.

The Lloyd's Act 1982 defines Lloyd's Brokers as the only firms that in their own names and by their own slips can place business directly with Lloyd's Underwriters. Byelaw No 5 of 1988 was passed in July 1988 in an effort to rectify a number of regulatory inadequacies which came to light following a series of scandals involving Lloyd's members, underwriters and brokers.

As a result, Lloyd's have now laid down stringent registration requirements for Lloyd's Brokers which include, inter alia, adequate capitalisation, prohibition from owning an interest in a Lloyd's Management agent, and adequacy of number and quality of staff as judged by the Council of Lloyd's. The Lloyd's Council requires all Lloyd's Brokers to carry professional indemnity insurance with liability limits of a minimum of £2 million and a maximum of £20 million, 75% of which must be placed with licensed insurers in the UK or in European Union Member States.

Furthermore, Lloyd's Brokers are prohibited from carrying on any business other than insurance brokerage and ancillary activities; and also from undue dependence on a particular insurer(s), source(s) of business, type(s) and/or class(es) of business.

Other factors taken into account include the organisational structure of Lloyd's Brokers, the types and standards of internal controls, etc. Lloyd's Brokers also have to comply with certain solvency requirements in order to guarantee that insurance and reinsurance monies received by the broker are sufficient to meet all liabilities to insurance and reinsurance creditors, and to provide a buffer against possible unidentified bad debts.

5. THE ROLE OF THE BROKER IN DEVELOPING COUNTRIES

Historically the insurance markets in most developing countries have evolved through the participation or involvement of either international brokers or

insurers/reinsurers by way of equity in and/or provision of technical support to domestic companies.

Following the withdrawal of foreign insurers from many of these countries as a result of the emphasis placed in recent years on the development of a local insurance industry, there was a considerable drain of much needed technical knowledge and skill in the insurance sector. Some of this vacuum was filled by the former insurance brokers who were operating in the direct insurance market in these countries. Many of them had international connections through whom they were able to provide the expertise and skills needed for negotiating, placing and servicing of both insurance and reinsurance transactions for local clients and insurance companies.

In addition to providing the normal broking services to the buyers of insurance in domestic markets, it is not unusual for these brokers to be involved in assisting the local insurer in securing competitive terms and sizeable capacity for risks such as aviation, industrial fire, storage risks, marine hull, engineering, etc. In carrying out this important function the broker's first-hand knowledge of local conditions and his intimate relationships with the carriers in the international market are of vital importance.

6. ADVANTAGES VS. DISADVANTAGES OF A BROKER-LED MARKET

The only argument which can be advanced against the advantage of a broker-led market is that increasing competitive pressures which brokers bring to the underwriters, if allowed to go unchecked, may lead to weakening of the financial strength of individual insurance companies. However, the counter argument to this disadvantage is that an agency system tends to have little competition between the insurance companies. In the agency system the client has to shop around visiting different agents in order to see where he can get the best deal

and usually does not have the expertise to do so. As already indicated, brokers have usually been strongly involved in the introduction of risk management systems, such as accident prevention and health improvement, introduction of loss prevention and loss minimisation measures etc., since part of their competitive armoury is the introduction of new products and the pressure they bring on underwriters to advance the state of the market.

However, it is equally important that the activities of brokers operating in domestic markets of developing countries are closely supervised and regulated in order to ensure a high degree of professionalism and integrity in the performance of their services. Brokers, like insurance companies, require regulation because as agents for the client they will be in the position of handling premiums and claims monies and giving advice of a very important nature to their clients.

Bearing in mind that many insurers or clients in developing countries may not be in a position to judge the behaviour of the broker objectively, it may become necessary in some markets to introduce regulatory and supervisory legislation. These rules may be on similar lines as those governing the conduct of insurance brokers in the UK and of Lloyd's brokers as detailed earlier in this paper. Alternatively, an altogether fresh set of rules could be incorporated in the legislation to suit local conditions.

Similarly, the regulation of insurance companies in a broker market will have to be of a very high standard, in order to ensure that there are no insolvencies of weaker insurance companies who have succumbed to a more competitive environment.

In recent years a number of countries, including Japan, South Korea, Taiwan and Sri Lanka, have introduced brokers in their markets. In general, brokers do not favour a system in which it is compulsory to use a broker or agent to purchase insurance, as is the case in some countries. They generally believe that there

should be a free trade system in which insurers can choose whether they accept business through brokers and/or agents or try and deal direct with clients, and the client is similarly able to decide how his business should be placed.

7. CHALLENGES FACING THE INSURANCE BROKER

What are the challenges currently facing the insurance broker?

Firstly, and perhaps inevitably, there is competition from other insurance brokers. Competition from this source is particularly aggressive in the mature markets, within which there is over capacity in the broking sector.

However, there are other competitive pressures. Most notably, these are direct dealing; increasing self-retention and the attractions of the risk management sector for the consulting companies and firms.

Secondly, insurance brokers carry high administrative costs. This is aggravated by the expenses of running off old business.

Further factors are the need to invest in information technology; the fact that legislation and self-regulatory provisions must be adhered to; the need to invest in higher quality personnel; and continuous professional development. All of these features need large amounts of money; and also significant periods of time.

Thirdly, there is, as always is, the need to be able to change when appropriate. Of crucial importance is whether the management is equipped for managing such changes. If attention is given to what changes will take place during the next ten years, then the following list can be compiled:

- Liabilities will increase
- Insurance products will change

- More insurance will be bought
- More capital will be needed (what's new?!)
- Costs will have to come down
- Insurance people will change
- De-regulation will appear
- Technology will affect all
- Information will improve
- Returns on equity will have to increase

To some, the above list represents problems. But in life:-

“There are no problems only opportunities. The problems themselves should therefore be classified as being opportunities”.

Increased liabilities exposure, the requirement for more not less insurance supported by new products present tremendous opportunities for the creative, innovative insurance broker.

Costs must be reduced, because ultimately costs and expenses are passed onto customers. But our customers will not pay these indefinitely. And so costs must be brought down. Information technology can help to achieve this aim. The great potential of information technology must be fully exploited otherwise we are missing an opportunity and failing in an obligation.

Customers are obviously of fundamental importance. Without them we cease to exist as a business entity. Consequently we must ascertain what they want. We have to listen to them and be proactive to their needs and concerns.

Finally, ladies and gentlemen, we must all bear in mind the following pearls of wisdom:

The winner is always a part of the answer

The loser is always a part of the problem

The winner has always a programme

The loser always has an excuse

The winner says let me do it

The loser says that is not my job

The winner sees an answer in every problem

The loser sees a problem in every answer

The winner says, it may be difficult but it is possible

The loser says it may be possible but it is difficult

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