Mactavish

BROKER CONFLICTS

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As the Covid-19 pandemic exposes the extraordinary mismatch of expectations between commercial policyholders and their insurers, this report asks hard questions about the role of the broker, how they earn their money and who pays them the most. In a second Mactavish report released in parallel we will explain how the mismatches in coverage expectations arise and why these are systemic across the insurance market and all classes of insurance.

Prior to the pandemic the insurance market had already become unstable after years of declining profitability as a result of which insurance premiums were rising. Covid-19 will now supercharge insurance rate increases and cover reductions to pay for the flood of claims and insurers' loss of investment income.

Policyholders appoint insurance brokers to represent their interests, but few understand that in a hard market their broker earns more money as premiums rise, presenting an obvious conflict of interest.

Brokers also receive substantial premium-linked revenue from services provided to insurers creating a second potential incentive to put the interests of insurers above those of clients.

A hopelessly conflicted and untransparent broker system has been allowed to develop during a long soft market but it is now being brutally exposed. A hard market exacerbated by a once in a generation Covid-19 recession gives this anachronistic structure nowhere to hide - and in the absence of stringent regulator action clients must drive reform alone by taking greater control of their placement.

In 2019 the FCA surprisingly closed their own investigations without addressing the inequity in the distorted system that favours brokers and insurers over policyholders.

In this context, why would you appoint a broker on an exclusive basis to act on your behalf, rather than competing them head to head and ensuring that these conflicts do not negatively impact your costs and cover?

The only option for commercial policyholders is to take control of the placement process themselves.

This paper has been prepared to help policyholders to achieve that and to understand how to manage and mitigate broker conflicts at a crucial time in the market cycle as the impact of the Covid-19 pandemic accelerates.

BROKER CONFLICTS

in the commercial market

Do you know how much your broker is being paid for services to your insurers rather than to you as a policyholder?

Most medium and large business policyholders use a broker to source and place their insurance risks such as property, business interruption or professional indemnity. Normally the client will negotiate a fixed fee with their broker for this specialist service and the broker is their agent – acting on the client's behalf to ensure they obtain the most appropriate cover at the best available price.

However, clients may not realise that the placement of their insurance can trigger a wide range of other payments to the broker by insurers, many tied to the premium placed with the insurers in return for services provided to them. As insurance premium rates are rising sharply in some lines of business, so these payments can far outweigh the fees brokers are paid by their clients. This, therefore, has the potential to lead to significant conflicts of interest.

This aspect of the market has long attracted attention, although concern is more limited if the values involved are small. But as insurance markets harden and prices rise, the risk of conflict for brokers escalates. As a result, we believe it is time this subject gets properly scrutinised to ensure that policyholders are fully able to understand the potential conflicts and talk to their brokers about how those conflicts are being managed and what effect they have on their insurance spend.

The purpose of this paper is to independently educate policyholders about the subject.

In February 2019, the Financial Conduct Authority (FCA) issued its Wholesale Insurance Broker Market Study (FCA Study)[1], the research for which was conducted prior to recent market hardening. While the FCA has decided not to pursue additional remedies at this time, the full report and appendices contain lots of evidence of conflict concerns buried in its detail – the conclusion is merely that the existing regulatory rules governing conflicts were sufficient.

The industry would therefore be wise to look beyond the headline of the FCA Study and analyse how the hard market works to further ramp up conflict potential, before concluding that the FCA findings denote a clean bill of health.

1 https://www.fca.org.uk/publication/market-studies/ms17-2-2.pdf

This paper considers two possible damaging effects of developments in broker remuneration derived from insurers:

1. **Does it affect where business is placed (potentially against client interests)?**
2. **Does it affect incentives to obtain the best price and terms for each client?**

The first issue refers to, in FCA terms, 'pay to play'. Are insurer payments to some brokers (relating to a variety of strategic and information services) genuine payment for value-adding services – or are they to obtain access to that broker's clients or an inducement to obtain a greater share of those clients' premiums?

The FCA has considered this question at some length and while we would have some queries with its methodology and conclusions – in particular while client transparency over such payments is limited – the validity of these payments is not a subject on which this paper will take a view.

The reason for this is that the second, simpler conflict remains and is rapidly worsening under current market conditions following the Covid-19 pandemic, and it is new. Even if payment structures do not influence which insurer a client's business is placed with, the broker is still financially incentivised to maximise the price its client pays, often by using suboptimal, over-standardised policy terms. These are often pre-defined as part of a broker scheme or facility designed for specific segments that also reduces workload and frictional cost. The mismatch in understanding of standardised policies between clients and insurers has also been starkly exposed by Covid-19 with wide ranging refusals by insurers to pay business interruption claims.

This misalignment of incentives remains irrespective of 'pay to play' and is drastically more pronounced in a hard market. FCA statistics suggest that across the market **nearly 80% of broker income is derived from insurers** as opposed to client fees.[2]

Not every broker takes payments from insurers. However, for those that do there is a disappointing lack of full transparency surrounding the form of these payments, the reasons for them and the sums involved.

Many broker terms of business agreements (TOBAs) pay lip-service to transparency while in practice doing more to confuse than clarify – discussing generalities of payment types in preprinted standard documents that do not set out what payments apply to the client's own case, or how much they are. These are important details and transparency standards in commercial insurance fall well short of those in the consumer segment.

As commercial organisations, brokers are at liberty to charge whatever they like for their services, including to insurers. However, with some commercial insurance brokers now being paid more from insurers in connection with a client's placement than from the client itself, it creates an extraordinary conflict that can only be managed with total transparency and by clients moving to a Written Lines Tender approach to drive genuine competition.

2 https://www.fca.org.uk/publication/market-studies/ms17-2-2-annex-4.pdf (points 13-14)

BROKER REMUNERATION
explained

For each insurance placement, the renewal report should contain details of the premiums quoted, alongside a breakdown of fees payable to the broker.

The fees might be a flat sum or a menu of fees for a range of services the client may choose to buy. Clients tend to focus on this section most because it is what they see as the amount they pay directly for the broker's service.

Fees have been on a downward trend for the past 10 to 15 years, a development which would seem to be good news for clients. Many commentators, Mactavish included, have long argued that fees are often now too low to provide a good service. We have also made the point that this is a major failure of sales and marketing on the part of the broking world to sell the value of insurance, and to help the insurance buyer communicate the value of that insurance to their board.

This race to the bottom on fees has actually helped create the transparency problem, since all other forms of insurer payment to brokers will almost certainly be ultimately passed on to clients indirectly as part of the premium paid.

The renewal documents should also detail all payments the broker receives from insurers in connection with the placement of the client's business, what services such payments relate to and any specialist scheme arrangements in place; far too often they fail to do this.

Such payments might include a simple percentage commission earned by the broker on the placement, although these were mainly intended to be phased out as clients moved to fees.

Many brokers will also include an 'insurer services brokerage' charge (ISB), which is said to relate to 'administration services' the broker provides in connection with the placement of the client's risk. Market opinions vary on the value of these services and whether in some cases they are indeed potentially illegal 'pay to play' payments, with some insurers privately saying the brokers do little for these charges.

It is not clearly set out which services are included in ISB and they are bundled with the risk placement, making any type of open market benchmarking of their value or the cost of service delivery impossible to assess. Where insurers do agree to pay ISB to the broker, the going rate is currently running at around 3.5% of the client premium usually without any cap, creating worsening conflicts of interest as rates harden. In some cases, ISB charges are 5% or more, which on its own is often equivalent to a doubling of the broker fixed fee. This seems impossible to justify in many cases as the services apparently being provided to insurers are an integral part of the core service also being provided to the policyholder such as processing premium payments and issuing documents - which does therefore, suggest brokers are being paid twice for the same job.

Sometimes, instead of negotiating terms with insurers in the open market, a broker will place the client's risk into a 'facility' or 'scheme' that the broker has pre-negotiated with one or more insurers to cover a portfolio of the broker's clients. The deal might be that the broker commits to the insurer(s) to put many or all clients of a certain type into the pre-negotiated facility providing an attractive volume of business. In return, the insurer(s) will agree to pay the broker a facility charge, often 10% or more of the client premium. In these cases, insurers may expect the broker to do more administration than on a normal open market placement. For example, the broker may prepare wordings and/or issue insurance policy documents on the insurer's behalf.

Even against the above backdrop, clients need to be aware that these payments may not cover everything a broker earns as a result of acting on a client's behalf.

Some placements will also involve facultative reinsurance, where the insurer pays a further commission to arrange onward reinsurance on the same client's risk.

Finally, beyond placement-specific income, a broker may also receive commissions from financiers for introductions to the client to offer premium finance to spread the payment of premiums. Again, these payments may be more frequent in a hardening market as rates rise. Much more significantly, some brokers also negotiate payments from insurers relating to their overall books of business from all clients. In such cases the addition of the client's risk to the portfolio is likely to increase the insurer's payment to the broker, either in the current year or the next time the payment is negotiated.

These portfolio arrangements might include further service agreements for providing data, analysis, advisory or R&D input to insurers, or even profit share arrangements on the portfolio. The structure of these arrangements will almost always reflect the size of the portfolio and so is affected by each client. There is a much wider industry debate as to whether these agreements are always justified by the services provided or whether in some cases they constitute 'pay to play' (see page 14), but whether or not this is the case, the potential for wider conflict created by misalignment of incentives remains clear and undeniable.

Broker account teams may not know the detail of what individual agreements are in place with each insurer, but it would be surprising if they were not aware that their business will generally make more money a) when their clients' premiums increase in a hard market and b) when broker schemes or facilities are used. So, the common defence given by broker account executives that they are ignorant of the financial rewards accruing to the broking house overall is somewhat disingenuous. In reality, we are being asked to believe that either these organisations are not good at disseminating crucial commercial information, or that they have clear processes for stopping the dissemination of this information - in which case, they could be explained and published.

Many brokers will also issue internal guidance on preferred insurers based on a range of factors, so there is a mechanism in place to influence placement – and widespread awareness of an institutional relationship being in place with certain insurers – even if the details of specific agreements are not known to account teams. This becomes even more significant when one considers the remuneration models adopted by broking houses. Earnings for individuals are often heavily dependent on bonuses that are usually determined by a mix of individual, business unit and overall company performance. This, unsurprisingly, is designed to align the interests of employees with the firm as a whole rather than them simply acting as franchisees or independent actors. It is, therefore, difficult to understand how brokers as institutions can claim that senior decision-makers who are directly involved in placement decisions are not influenced by their knowledge of financial relationships between the firm and its insurer partners. If the point of such bonus structures is to align the interests of the individual with those of the company (a laudable aim) it seems naïve to suggest that such alignment doesn't occur when it comes to the core aspect of a brokers job – placing risks in the market.

As the FCA put it in their 2014 thematic review into broker conflicts of interest:

"[Broker] management relied heavily on the belief that individual brokers acting as agent of the customer would always act in the best interests of those customers… [some brokers] did not appear to appreciate that this position is threatened where the individual broker's impartiality and independence could be affected by group relationships or differential remuneration structures. It was also not clear how an individual [customer] file could present a complete picture of the placement when elements of the placement decision had been taken elsewhere in the [broker] (i.e. when the facility was put in place)".[3]

The key question remains: do clients know what their brokers earn from insurers for providing services to the insurer as a result of the client's placement, either directly or because it is part of a portfolio payment? The net balance of remuneration derived from clients and insurers is considered in the next section of this paper, also drawing on FCA statistics. Mactavish believes the only viable solution to this problem is for commercial policyholders to run head-to-head tenders with brokers (Written Line Tenders) and demand full and account-specific transparency so that they can take an informed view of the potential conflict created, and negotiate to rebate and replace any elements of concern through adjustments to their fee.

To do this, brokers at a case level should proactively disclose every aspect of remuneration applying to the placement in the client renewal report and explain the services to which each fee relates. This should not only include all sources of broker placement income but also an estimate of the non-placement, portfolio-level income attributable to the client's share of premium. This may take some effort to analyse and allocate sensibly within client disclosure but the task cannot be insurmountable if the desire to be transparent exists. If this is not done, client conflicts will always remain unmanageable.

In a free market, insurers and brokers can negotiate whatever deals they want with the range of charges reflecting the distribution power held by some brokers. Given the obvious potential for conflict, it is essential that such arrangements are disclosed in detail to the client for them to make an informed placement decision. In the end, it is all the client's money.

3 https://www.fca.org.uk/publication/thematic-reviews/tr14-09.pdf (p.10)

THE HARDENING MARKET

is making things worse

Insurance is a cyclical business, with prices softening and hardening according to the usual economic factors of supply and demand.

An excess of insurance capital (supply) in the market since the financial crisis has led to an unusually long 'soft' market, with premiums remaining low for more than 10 years. Conditions in 2019 started to shift, however, with premiums hardening across several classes of insurance. Following the severity of the economic slowdown in 2020 during the Covid-19 pandemic (and specifically its impact on investment markets and insurer balance sheets, which is expected to be far greater than the direct impact of pandemic related claims), this dynamic has taken firm hold and the soft market is already fading into a distant memory for clients who have renewed in recent months.

Given the links between client premiums and broker payments from insurers it is not hard to see why this is exacerbating the risk of conflicts of interest. At a market-wide level, statistics from the FCA confirm the validity of concern over the total makeup of broker income. Looking across all complex London market placements, the FCA Study data found that the proportion of broker income derived from client fees had already declined from 27% of the total in 2012 to just 22% in 2016[4] (or an even greater reduction from 39% to 28% for the big three brokers) – with between 70% and 80% of broker income coming from insurers and being linked to premium in some way.

Some of that insurer-derived income will be direct, disclosed commission that is charged legitimately in lieu of a client fee. Although this still creates a misalignment of incentives by rewarding the broker for a higher price, provided they are disclosed such commissions are a legitimate alternative to a fee in paying for the core broker placement activity. However, a breakdown of the various constituents of placement and non-placement related broker income described in this paper is not included in the FCA Study, so we cannot be certain how much such direct commission represents. However, with commission-based placements in decline across much of the corporate market (with the exception of some specialist classes or types of 'international wholesale' placement), the vast majority of this figure would appear to be for services to the insurer. What's more, even this measured 22% contribution to broker income from client fees will have shrunk further since 2016 due to hardening rates – since all premium linked payments rise proportionally. To have client fees making up only one-fifth of their agent's total income is structurally very difficult to manage.

In summary, your broker is potentially getting between three and four times what you pay them (to place your insurance) from the insurers with whom they place your business in return for services they provide to those insurers, either in connection with the placement of your business or as part of a portfolio. And the value of those payments may increase in line with rising premiums driven by the Covid-19 pandemic.

4 https://www.fca.org.uk/publication/market-studies/ms17-2-2-annex-4.pdf (points 13-14)

The potential for conflict of interest in commercial insurance has arisen from soft market developments – and been permitted by regulators despite the criticisms in the FCA study - but has escalated unacceptably in the hard market as premium-linked service payments to brokers rise rapidly while the services provided to insurers in most cases remain exactly the same. In addition, the impact of such schemes also raises serious questions for clients following a difficult placement. Is the standardised scheme cover the most appropriate option? Have other insurers been asked to quote who could have offered better or more tailored coverage? In previous hard markets, one of the broker's key roles was to create competition by identifying new capacity. This role is undermined if any new insurer acts as competition to, or is automatically redirected into, the broker scheme – potentially further exacerbating the hard market impact for clients.

We doubt that any blank sheet analysis aimed at best servicing commercial policyholders would recommend this business model if starting from scratch.

This can be shown by two illustrative examples based on our recent market experience.

SCENARIO ONE

A business paid a premium of £1m in 2018, arranged via a broker to whom the client pays an annual flat fee of £50,000. The broker also receives a 3.5% ISB charge from the insurer and has a service agreement in place with insurers on the programme that is worth an additional 2%. On a £1m premium this means insurer payments to the broker were £35,000 and £20,000 respectively. So already, even in a soft market and without exploring all the other possible income sources above, the broker earned more for providing services to the insurer than the £50,000 it did for providing services to the client.

However, with insurance prices rising in 2019, the risk is now costing £3m to insure, even on far more restrictive terms. The client will still pay the same £50,000 fee, but the insurer payments to the broker will now amount to £165,000. By being appointed as the agent to that client, the broker earns less than 25% of its money from the client and over 75% by providing services to the insurers that underwrite the risk.

SCENARIO TWO

A client discovered that its insurance programme had been largely placed in broker facilities for several years, a fact which had never been explained. The renewal report clearly set out ISB (at 3.5% of premium) but the client was unaware of the facility basis (which included a range of additional broker charges ranging between 5 and 15% of premium).

The broker fee of £50,000 remains relatively competitive, at around 4% of the premium but ISB and facility income from the insurers adds up to more than double the fee. The end result is that the client contributes less than one-third of their agent's direct earnings (again before considering the additional broker income sources noted in this paper).

While the scenarios will not always apply to every situation, they illustrate widespread potential for highly material conflicts of interest. Can a broker be said to represent the client's best interests if most of its income comes from providing services to insurers? Could the structure of such payments influence broker recommendations on the choice of insurer? Even if the rates are the same between insurers, could benefitting financially from higher prices influence broker enthusiasm for negotiating the best deal for their client? Where broker remuneration is so heavily skewed on the insurer side, and is not fully disclosed, it is impossible for the industry to adequately answer these questions.

WHAT
can be done?

Current broker remuneration practices have become embedded in the insurance marketplace over the past 30 years. With premiums rising and full transparency very rare, buyers of commercial insurance should be wary of the sharply increased conflict potential as markets harden.

Mactavish's concern is not so much about how much money the broker earns (indeed, we actually believe that client fees – considered in isolation from other forms of revenue – are too low) but whether the obvious and substantial conflicts of interest that we describe in this paper compromise clients on both premiums and cover. We are not commenting on the overall level of earnings of the brokers, simply the structure of remuneration that means that the less hard they try in a hard market the more they earn. The only solution to this is to both compete brokers head to head in a Written Lines Tender and demand enhanced remuneration disclosure as part of that process.

WHAT CAN CLIENTS ASK FOR?

Commercial insurance clients can, of course, make informed decisions even faced with a complex mix of broker remuneration. But nobody can do this without transparency. This is why we call for proactive, complete disclosure by brokers of all case-level income – including estimates of the share of portfolio arrangements applying and explaining what services are provided for each component.

Clients should insist on this level of detail and this paper helps them to do exactly that. However, while Mactavish can help clients to ask the right questions, we also take the view that the industry, and its governing bodies, should make this process far easier.

In addition, brokers should be required to disclose the overall value of all premium placed with each insurer and the total value of all remuneration received from each insurer, covering all placement and non-placement related income. Such a comparative summary would give clients the information needed to assess their own insurer recommendations and ask informed questions about potential conflicts. This would appear to be a relatively straightforward reporting requirement to help clients cut through the current complexity.

The broker TOBA small print can help clients to flush out the detail, although there are two common flaws. First, remuneration disclosure is normally available only on client request, rather than having to be proactively provided by the broker. Second, most TOBAs reference only the generality of payments from insurers, rather than requiring any disclosure or estimation of what applies to a specific client. This is clearly not enough to support a properly informed placement decision.

Many TOBAs assume a level of client disinterest in agent remuneration that we believe is not appropriate as the market hardens and remuneration is more heavily skewed towards insurer-based income. Such brokers need to move their TOBA agreements away from explaining remuneration in a way that only appears designed to tick a compliance box and towards supporting real transparency and understanding, without which clients will often view such explanations as cynical.

Like any organisation, brokers might be reluctant to reveal commercially sensitive information and some of the terminology used to explain arrangements with insurers can be difficult to decipher. Some brokers are well-versed in responding to client enquiries in a technically correct way but which may fail to give the information the client really needs. For example, as noted above, the broker may report that portfolio-level remuneration is not linked to individual accounts so they cannot apportion the income received.

However, we take the view that if it affects incentives as materially as the above scenarios make clear, this is failing to answer the question.

Without a clear sense of how exactly the broker benefits from insurer 'supply side' relationships, it is impossible for buyers of insurance to assess the scale of their broker's potential conflicts of interest when selecting insurance arrangements. From any modern corporate governance viewpoint, this is outdated and untenable. Naturally, in a market with so few major players relationships between brokers and underwriters will always be close, but with improved transparency and clarity, clients would be in a better position to assess those relationships and to manage the likely impact on their risk transfer arrangements.

Buyers can manage the situation more directly by introducing competition between brokers during the tender process itself, rather than appointing an exclusive broker based on a conceptual tender. This Written Lines Tender approach involves treating the insurers and brokers together as 'the market' and allowing them to compete head to head - with each broker working with their preferred insurers. The client selects the best combination of price and cover as an entire solution, effectively using competition to manage the underlying conflicts in the absence of transparency. This may in some cases increase the management burden on insurance buyers but we have seen many examples of this approach resulting in improved cover at significantly reduced cost. This is an effective workaround to the conflict position and in the end, it is the only real available policyholder management option.

What about the **REGULATOR?**

The FCA Study noted as one of its introductory headlines, the large recent increases in service payments to brokers by insurers and the proportion of business placed in broker schemes – both increasing the potential for conflict.[5]

Given these headlines, the FCA's conclusion was surprising to many:

"We have not found evidence of significant levels of harm to competition that merit the introduction of intrusive remedies. As a consequence, we are closing our market study and this is, therefore, not an interim report but our final report"[6]

Although the FCA accepts that structural conflicts arise in the areas explored in this paper, following up on its earlier 2014 thematic review into broker conflicts in the SME segment, it reported a lower degree of concern over competition issues. The regulator's view is that these conflicts are addressable using existing regulatory means – although the FCA Study notes recurring limitations in broker conflict management procedures and transparency:

"[We have] identified some areas which warrant further action, in relation to conflicts of interest (CoI), the information firms disclose to clients and certain specific contractual agreements between brokers and insurers."[7]

The macro-level analysis of competition effects in the FCA Study does not chiefly focus on the conflicts and lack of transparency that emerge at a case level, which is where we believe the main problems lie. This approach also explains why some of the anecdotal concern over case-level conflicts and market distortion cited by the FCA as having been reported by on-the-ground practitioners was more stark than its own conclusions on the overall effect on market competition.

5 https://www.fca.org.uk/publication/market-studies/ms17-2-2.pdf (p.4)
6 https://www.fca.org.uk/publications/market-studies/ms17-2-wholesale-insurance-broker-market-study
7 https://www.fca.org.uk/publication/market-studies/ms17-2-2.pdf (p.3)

Although the FCA Study was heavily misreported in the press as giving a 'clean bill of health' to the industry overall, the lack of further FCA sanction does not in fact mean that the industry is in the clear regarding conflicts. The EU Insurance Distribution Directive (IDD) sets out the general principle that brokers should not be remunerated "in a way that conflicts with their duty to act in accordance with the best interests of their customers".[8] The FCA's implementation of this through changes to the Senior Management Arrangements, Systems and Controls regime as well as the Insurance Conduct of Business Sourcebook (ICOBS) means this principle applies to all commercial broking and that directors and senior management need to take "appropriate practical responsibility"[9] for such matters. In consultation with Mactavish in advance of the publication of this study, the FCA was keen to stress that absence of further proposed remedies simply reflected their view that the existing rules governing conflict and existing supervisory activities were sufficient to enable them to address conflict concerns, not that there are no conflict issues that require attention. Broker 'conduct risk' remains a critical issue.[10]

In responding to the press coverage of the FCA Study, some brokers themselves reported concern that the market is becoming overly skewed by the arrangements some players have negotiated. Broker auditing firm PKF Littlejohn commented:

"Many brokers expected the review to result in the regulator intervening in what they perceive is an unbalanced market... It will also be interesting to see if one of the unintended consequences of the report may be growth of ever more innovative non-placement-based commissions."[11]

The FCA clearly recognises the conflicts that exist in insurance broking. However, to date its published work in our view does not delve deeply enough into case-level conflict potential or the adequacy of transparency standards adopted in practice. Whether or not existing regulatory mechanisms are adequate is not the point; a vastly more proactive approach is required to address the sheer scale of conflict potential which has been allowed to develop and what it now means in the context of global economic catastrophe. Aside from 'pay to play', which is not our main focus in this paper, but is summarised on the next page, the FCA's conflict analysis makes some key points but is limited by three key factors:

1. Conflict analysis in the FCA study focuses on quantifiable differences in client outcomes between schemes/MGAs and the open market (concluding that broker income is higher in such arrangements and conflict management procedures at some brokers are lacking). However, the analysis does not review conflicts affecting the open market in the first place: conflict potential is driven by all premium-linked income derived from insurers, not just schemes and MGAs.

2. Remuneration analysis focuses on the comparison between different market segments and potential for excess profitability, rather than the FCA providing detailed analysis into the breakdown of broker remuneration, its structure and sources – the factors that can drive conflict.

3. Transparency analysis focuses on surveyed client satisfaction with knowledge of how their broker is paid, without analysing which income sources were in fact disclosed. To the extent that the FCA Study did look at actual broker disclosure, the FCA found it to be inconsistent, incomplete and often only made available if specifically requested.[12]

8 https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:32016L0097 (Article 17(3))

9 https://www.handbook.fca.org.uk/handbook/SYSC/1/2.html (SYSC 1.2)

10 https://www.brownejacobson.com/insurance/about-us/published-articles/2019/03/its-the-conduct-risk-stupid-fcas-study-of-competition-in-london-wholesale-insurance-broking-market

11 https://www.insurancetimes.co.uk/news/london-broker-market-avoids-fca-sanction-in-wholesalereport/1429569.article

12 https://www.fca.org.uk/publication/market-studies/ms17-2-2-annex-5.pdf (points 46-48)

WHAT IS ‘PAY TO PLAY’?

‘Pay to Play’ is a term used in the insurance market to denote the concept of an insurer being asked to make payments to brokers to obtain the chance to bid on their clients, or to attract a greater share of their client business. Such practice attracted significant regulatory criticism in the 1990s and 2000s, in particular when allied to profit-sharing or contingent commission deals, which were felt to distort fair competition.

There has been a proliferation in recent years of insurer-broker service agreements, covering a range of offerings including client data analysis, wording advice, strategic advisory and R&D input to insurers. The FCA Study analysis on this point shows that such agreements in some form exist between almost all the larger insurers and larger brokers (with deals in place for every UK top 10 insurer with almost every top seven broker at the time the study was conducted), and their financial value is aligned to where premium volume is greatest. They comment:

“we found that, on average, insurers that sign non-placement agreements with a broker receive a larger share of that broker’s business compared to insurers that have not signed an agreement with that broker” ”[13]

The FCA Study is inconclusive as to whether they consider this sufficient evidence of ‘pay to play’ in action, although it remains a stark observation. Many insurers dislike the range of payments sought by some brokers and in some cases dispute that the charges are a fair reflection of the work brokers do for them or even the accuracy and value of the data provided. Mactavish believes it would also be unusual in other sectors for companies to buy strategic or advisory services concurrently from all the major competitors. Often brokers will defend the position to clients by suggesting that as long as client-facing account teams are not privy to the detail then such agreements cannot affect outcomes.

This may not be ‘pay to play’ as such but as long as there is potential for these arrangements to influence placement, they should be disclosed to clients. If ultimately the cost of such services is passed back to the client via premium, such agreements should not fall outside of client transparency disclosure as they do today.

13 https://www.fca.org.uk/publication/market-studies/ms17-2-2-annex-4.pdf (point 17)

CONCLUSION

Brokers, like other professional service providers, are perfectly entitled to charge what they choose for the services they provide. However, current market practice means it is increasingly common for a broker to be paid a greater sum by the insurers, via a wide range of income sources, than the sum being paid by the client. Given the broker's legal duties as an agent of the client, this creates the potential for an extraordinary conflict of interest.

Mactavish has long argued that broker fees are too low to reflect the amount of work and technical expertise brokers are expected to provide, and this has contributed to the current problem. It is a moot point whether some brokers subsidise their low fees by aggressively increasing payments from insurers, or whether lucrative payments from insurers have encouraged some brokers to 'buy in' business from clients at low fees. Either way, rising premiums in a hardening market exacerbate the problem at a time when clients facing an unprecedented economic slowdown need all the support they can get if they are to survive.

As we have stated, the obvious solution in theory is for policyholders and regulators to push the industry as a whole to act with full transparency. While this wouldn't remove the conflict of interest, it would allow insureds to assess its likely impact on their risk transfer programme. However, this is unlikely to happen in the near future; in part, because the globalised nature of the major insurers and brokers means that they cannot currently apportion the value of the services they pay a particular broker for against individual client accounts. This means that at the level of individual client/broker/insurer relationships such transparency is unlikely to be forthcoming.

This leaves policyholders who are dissatisfied with the current situation with few options. In practice, Mactavish believes that the only way they can guarantee a fair insurance outcome is by creating a competitive environment between brokers and insurers by running Written Lines Tenders at regular intervals where brokers compete head to head against each other with each broker working with their preferred insurers. The outcome is that the broker and insurer/s with the best offer in terms of price and cover are appointed as an entire solution and customers move away from the exclusive use of a single broker. While this will increase the management burden for insurance buyers, from the examples Mactavish has seen, the cost savings and improvements in quality of coverage achieved by this approach can be highly material. It is a powerful and successful customer response to the remuneration conflicts.

Crucially, the issues we've identified in this report should be understood not only by those who are directly responsible for purchasing insurance, but also by the board members and executives who are ultimately responsible for the governance and management of companies. Without their backing, insurance buyers will lack the resources they need to push for better outcomes. That, in turn, will mean that those companies will both pay more for their insurance and find that the policies they buy do not necessarily offer the cover that they are depending on in the event of a large loss event.

Covid-19 has created a perfect storm as prices rise, available cover contracts radically and brokers are inundated with queries around potential claims and rapidly worsening renewal expectations at a time when most companies are furloughing staff, making redundancies and cutting all but essential spending. The insurance industry is being asked some reasonable but uncomfortable questions on the extent to which it is sharing the real economy's pain while most pandemic related claims are rejected and premium rates increase. Brokers too may yet suffer (if nothing else, bankrupt companies can no longer buy insurance) but many brokers' first quarter results in 2020 have shown top line growth – which certainly cannot be said for most other sectors. In this context, a conflict position which was already impossible to justify on closer examination in a soft market is grossly unfit for purpose today.

WHAT IS YOUR BROKER EARNING?

Placement income

1. Client fee: paid by the client as a flat service fee or including add-ons for optional services such as claims handling or risk engineering
2. Commission: may be charged as an alternative to a client fee or in some circumstances in addition. Levied as a percentage of the premium and paid by the insurer. If applying in addition to a fee, may sometimes be rebated to the client.
3. Insurance services brokerage (ISB): a standard additional levy paid by many insurers to many brokers for unspecified administrative services in connection with the client's specific placement, usually as a percentage of the premium between 3.5% and 5% although sometimes more
4. Reinsurance commission: if an insurer passes part of the risk on a client-specific 'facultative' basis, the broker may earn further commission on that placement, as a percentage of premium
5. Investment income: brokers may hold client money on account before passing it on to the insurer, making investment income on those funds based on the volume of premium
6. Scheme/facility or work transfer fees: service fee sometimes applying to all business placed by a broker with a given insurer in a pre-arranged facility, typically paid by insurers as a percentage of the total value of client premiums in the facility

Non-placement and 'portfolio-level' income:

1. Information or advisory service fees: payments sometimes made by insurers to brokers for aggregated client information, wording advice, R&D or strategic advice. Negotiated on a case by case basis but often as a "broad" percentage of premium across the portfolio either for the current or previous year
2. Profit share or profit commission: an additional payment sometimes agreed between insurers and brokers based on the financial performance of the portfolio of clients held with that insurer. Structure varies but income will typically be linked to both premium volume and underwriting profitability. This means the payments to brokers increase if premiums rise and claims payments are kept low.
3. Referral payments: fee or commission payments may be received from third-party service providers recommended by some brokers, including lenders and premium finance companies whose services may be needed if premiums rise steeply.

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To find out more, please contact:

Telephone: +44 (0)207 993 0662
Email: mail@mactavishgroup.com

www.mactavishgroup.com