Insurance Broking: Placement, Advice and Remuneration

Interview preparation summary · IN track

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INT.NH.1.a · Role, placement and remuneration

Explain what an insurance broker does as the client's agent, distinguish retail, wholesale and London market broking, and trace how premium and brokerage flow between the parties.

An insurance broker is an intermediary that normally acts as the agent of the client, the buyer of insurance, and not of the insurer. It advises on the risk, designs the cover, approaches insurers, negotiates terms and helps with claims. Retail brokers deal directly with businesses or individuals. Wholesale brokers sit one step back: they receive business from other brokers and place it with specialist insurers, often in the London market, which includes Lloyd's, where syndicates share large and complex risks on a subscription basis. A broker may work in practice areas such as property and casualty, employee benefits, where it advises an employer on group life, health and pension arrangements, and reinsurance broking, where the client is an insurer buying reinsurance. Premium normally flows from the client through the broker to the insurer, and the insurer pays brokerage, usually out of the premium, to the broker or brokers involved. The details of who holds premium and under what protections are set by regulation and vary by country; in the UK the Financial Conduct Authority sets client money rules. Interviewers look for the agency idea and for a clear picture of who is paid by whom. The common mistake is to think a broker works for the insurer because the insurer pays the brokerage.

WORKED EXAMPLE: PREMIUM AND BROKERAGE THROUGH A RETAIL AND A WHOLESALE BROKER

A business pays a total premium of £500,000. A retail broker places the risk through a wholesale broker into the London market. Total brokerage is 18% of the premium, shared 60% to the retail broker and 40% to the wholesale broker. All figures are illustrative; real terms vary and should be checked. Find what each party receives and say whom each broker acts for.

Answer: The retail broker receives £54,000, the wholesale broker £36,000 and the insurers £410,000, and the client's interests lead the chain.

> **Interview tip:** Say that the broker is the client's agent, then trace the money and name who receives each part. Add that brokerage is paid by the insurer from the premium, so the client's price includes the broker's income.

INT.NH.1.b · Role, placement and remuneration

Describe the placement process from client brief and submission to quote, negotiation, firm order and binding, and work out signed lines and premium shares when a subscription placing is oversubscribed.

Placement starts with the client's brief and the information the broker gathers: what is to be insured, values, loss history and the cover wanted. The broker builds a submission for underwriters, chooses which insurers to approach and invites quotes. A lead underwriter usually sets the price and main terms, and following insurers write a share, called a line, of the risk on the same terms. The broker negotiates price, wording and security with the client's interests in mind, and the client chooses. When the client instructs the broker to proceed, the broker seeks firm order terms and asks insurers to commit their lines, after which the risk is bound, with any conditions that remain open called subjectivities. Documents such as the slip, the policy and the premium and claims arrangements follow. If lines offered add up to more than 100% the placing is oversubscribed and lines are signed down, often proportionately, so that they total 100%; if they total less, the broker finds more capacity or changes the structure. Interviewers expect the sequence in order and a feel for how lines and premium are shared.

WORKED EXAMPLE: AN OVERSUBSCRIBED SUBSCRIPTION PLACING

A broker places a property risk with total premium of £660,000. Four insurers offer written lines of 35%, 30%, 25% and 20%. The illustrative lines add to more than 100%. Find the signed lines if they are signed down proportionately, and each insurer's share of premium.

Answer: Signed lines are 31.8%, 27.3%, 22.7% and 18.2%, and the premium shares are £210,000, £180,000, £150,000 and £120,000.

Interview tip: Give the steps in order, then show the arithmetic of signing down. Mention that competition among insurers is a lever the broker can use for the client.

INT.NH.1.c · Role, placement and remuneration

Explain how brokers are paid through commission, fees and contingent commission, work out the income and cost to the client of each, and explain the conflicts of interest and how they are managed.

A broker is paid by commission, a share of the premium paid by the insurer, or by a fee agreed with the client, or by a mix of the two. Contingent commission, also called an override or profit commission, is an extra payment from an insurer based on the volume or profitability of the business a broker places with it. Because the insurer pays the broker, there is a conflict of interest: a broker could favour an insurer that pays more even when another quote is better for the client. After regulatory investigations in the United States in the mid-2000s, large brokers moved away from some contingent arrangements and towards more disclosure. The usual management of the conflict is to put the client's interests first, disclose how the broker is paid, record the reasons for a recommendation, and agree fees openly. The client's total cost is the gross premium plus any fee, so the comparison between quotes should be on cost and cover and not on commission. Rules on disclosure vary by country and should be checked. Interviewers look for an honest view of the conflict, not a claim that there is none.

WORKED EXAMPLE: WHICH QUOTE DOES THE BROKER RECOMMEND

A client's cover is identical on three quotes of equal security. Insurer A: gross premium £250,000 and commission 12%. Insurer B: £245,000 and 20%. Insurer C: £238,000 and 8%. All figures are illustrative. Find the broker's income from each, say which quote the broker should recommend, and compare a fee option.

Answer: The broker earns £30,000, £49,000 and £19,040, but should recommend C, which is cheapest for the client.

Interview tip: Name the conflict openly, say the client's interest decides the recommendation, and say you would disclose the broker's remuneration and keep a record of the reasons.

INT.NH.2.a · Programmes, economics and conduct

Explain how a broker places a programme in layers and a facultative reinsurance, and how risk advisory and claims advocacy add value, by allocating a loss across the layers and working out rate on line.

A large client rarely buys all its cover from one insurer. The broker builds a programme: the client keeps a deductible, a primary layer covers the first part of a loss, and excess layers sit above it, each placed with different insurers and priced separately. The rate on line of a layer is its premium divided by its limit, and it falls as layers go higher because they are less likely to be hit. A loss is allocated from the bottom up: each layer pays only the part falling inside it. Facultative reinsurance is the reinsurance of a single risk, negotiated for that risk alone, as opposed to a treaty that covers a portfolio; a broker places it for an insurer that wants to pass on part of a large risk. Beyond placement, brokers give risk advisory services, such as helping to understand exposures and choose limits and deductibles, and claims advocacy, which means helping the client to notify, document, present and negotiate a claim and to collect payment. See Reinsurance for treaty terms. Interviewers look for the arithmetic of layers and for an understanding that service continues after the policy is bound.

WORKED EXAMPLE: A £100M PROPERTY PROGRAMME FOR A MANUFACTURER

A client buys a deductible of £1m and three layers: £24m excess of £1m for £1.5m, £25m excess of £25m for £0.75m and £50m excess of £50m for £0.6m. Figures are illustrative. A fire causes a loss of £40m. Find the rate on line of each layer, the total premium and what each party pays.

Answer: Rates on line are 6.25%, 3.0% and 1.2%, the premium is £2.85m, and the layers pay £24m and £15m after the client's £1m.

Interview tip: Walk up the layers from the bottom, state who pays what, and say why the rate on line falls. Mention that a broker's job continues through the claim.

INT.NH.2.b · Programmes, economics and conduct

Explain broker economics, including organic growth, retention, headcount and revenue per head and M&A consolidation, and work out organic growth, revenue per head and the price paid for an acquisition.

A broker earns revenue mainly from commission and fees, so its income grows or shrinks with premium rates, the volume of exposure, the clients it wins and the clients it keeps. Organic growth is growth from existing operations, before acquisitions: roughly new business as a share of prior revenue, minus the share lost through lower retention, plus the effect of rate and exposure changes. Retention is the share of revenue kept from one year to the next. Headcount is the largest cost, so revenue per head is a common measure of productivity, and profit is usually measured as an EBITDA margin. Many large brokers have grown by buying smaller ones, adding scale, new products and new markets; the price is often described as a multiple of EBITDA, and the acquired revenue is reported separately from organic growth. A soft market lowers premium rates and so the broker's commission income, even if clients are retained, while fee income is less affected. Interviewers look for care in separating organic from acquired growth and for sensible questions about margins and retention.

WORKED EXAMPLE: PEMBERTON BROKERS: GROWTH AND AN ACQUISITION

Pemberton Brokers, an invented broker, has revenue of £200m and 1,000 staff. Retention is 92%, new business is 10% of last year's revenue and rate and exposure effects add 3%. It plans to buy a broker with revenue of £20m and EBITDA margin of 25% at 10 times EBITDA, adding 80 staff. Illustrative figures. Find organic growth, next year's revenue and revenue per head, and the price as a multiple of revenue.

Answer: Organic growth is 5%, revenue rises to £230m with the acquisition, revenue per head is about £213,000, and the price is £50m, 2.5 times revenue.

> **Interview tip:** Separate organic growth from acquired growth, and say what you would ask about retention and margin. Say that a price of 10 times EBITDA looks high or low only against growth and risk.

INT.NH.2.c · Programmes, economics and conduct

Explain a broker's duty to the client, the client's duty of fair presentation, errors and omissions exposure and how conflicts are managed, and work out the effect of a non-disclosure on a claim under a proportionate remedy.

A broker owes its client a duty to act in the client's interests with reasonable skill and care, to advise on suitable cover, to be open about how it is paid and to manage conflicts. In the UK, for commercial insurance, the Insurance Act 2015 places on the insured a duty of fair presentation: to disclose every material circumstance it knows or ought to know, or give enough information to put the insurer on notice to ask further questions. The broker helps the client to meet that duty, and a failure can be the broker's fault. Where the breach is neither deliberate nor reckless, the Act gives the insurer remedies in proportion to what it would have done: if it would have charged a higher premium, it pays the claim in the proportion of the premium charged to the higher premium. A client who loses cover through the broker's negligence may claim against the broker, which is why brokers hold professional indemnity insurance, often called errors and omissions cover. This is UK-specific: other countries have different rules, and current practice should be checked. Interviewers look for the habit of asking whether information is complete and for honesty about conflicts.

WORKED EXAMPLE: A CLAIM CUT BY NON-DISCLOSURE

A business pays a premium of £80,000. The insurer later shows that, had it known of an earlier flood loss, it would have charged £100,000. The business then has a flood claim of £1.5m. Assume the UK proportionate rule applies and the breach was careless. Illustrative figures. Find what the insurer pays, the shortfall and who may bear it.

Answer: The insurer pays £1.2m and the shortfall of £300,000 falls on the client, or on the broker and its professional indemnity insurer if the broker was negligent.

> **Interview tip:** Say whose duty fair presentation is, that the broker helps to meet it, and that the claim is reduced in proportion. Say this rule is UK-specific and that you would check the details.