THE ROLE OF INSURANCE INTERMEDIARIES

Introduction

The importance of insurance in modern economies is unquestioned and has been recognized for centuries. Insurance "is practically a necessity to business activity and enterprise." But insurance also serves a broad public interest far beyond its role in business affairs and its protection of a large part of the country's wealth. It is the essential means by which the "disaster to an individual is shared by many, the disaster to a community shared by other communities; great catastrophes are thereby lessened, and, it may be, repaired."

Insurance is *an essential element in the operation of sophisticated national economies* throughout the world today.

Without insurance coverage, the private commercial sector would be unable to function.

Insurance enables businesses to operate in a cost-effective manner by providing risk transfer mechanisms whereby risks associated with business activities are assumed by third parties. It allows businesses to take on credit that otherwise would be unavailable from banks and other credit-providers fearful of losing their capital without such protection, and it provides protection against the business risks of expanding into unfamiliar territory – new locations, products or services – which is critical for encouraging risk taking and creating and ensuring economic growth.

Beyond the commercial world, *insurance is vital to individuals*. Lack of insurance coverage would leave individuals and families without protection from the uncertainties of everyday life. Life, health, property and other insurance coverages are essential to the financial stability, well-being and peace of mind of the average person.

Insurance is a financial product that legally binds the insurance company to pay losses of the policyholder when a specific event occurs. The insurer accepts the risk that the event will occur in exchange for a fee, the premium. The insurer, in turn, may pass on some of that risk to other insurers or reinsurers. *Insurance makes possible ventures* that would otherwise be prohibitively expensive if one party had to absorb all the risk.

Advancements in medicine, product development, space exploration and technology all have become a reality because of insurance.

Consumers buy automobile insurance to cover both their cars and people who may be injured in accidents. Homeowners and renters buy insurance policies to protect their property and protect themselves from liability. People buy life and health insurance to protect themselves and their families from financial disaster in case of illness or death.

In some instances, governments require businesses to purchase insurance. Known as financial responsibility requirements, government-mandated purchases of insurance is intended to ensure that injured parties will be compensated. Businesses also require other businesses to buy insurance. For instance, a retailer may require its suppliers to carry product liability insurance. Similarly, hospitals may require doctors to carry medical malpractice insurance, and mortgage firms often require their clients to insurance the properties used as collateral.

Distribution of insurance is handled in a number of ways. The most common is through the use of insurance intermediaries.

Insurance intermediaries serve as the critical link between insurance companies seeking to place insurance policies and consumers seeking to procure insurance coverage.

Intermediaries, traditionally called “brokers” or “agents” or “producers,” offer advice, information and other services in connection with the solicitation, negotiation and sale of insurance.

Over the last two decades, many professional intermediaries have developed services that go beyond the services related to the transferring of risk from insureds to insurers;

Intermediaries now offer services such as the evaluation and implementation of alternative means of funding for potential losses, risk management strategies and claims management.

This paper will explain what an insurance intermediary is, the role of intermediaries in the insurance marketplace and the wider economy, and the services provided by intermediaries to insurance providers and consumers. It will also briefly describe the legal and regulatory regimes governing the business of insurance around the world.

Insurance Intermediaries

Insurance intermediaries facilitate the placement and purchase of insurance, and provide services to insurance companies and consumers that complement the insurance placement process.

Traditionally, insurance intermediaries have been categorized as either insurance agents or insurance brokers. The distinction between the two relates to the manner in which they function in the marketplace.

Insurance Agents

Insurance agents are, in general, licensed to conduct business on behalf of insurance companies. Agents represent the insurer in the insurance process and usually operate under the terms of an agency agreement with the insurer. The insurer-agent relationship can take a number of different forms.

In some markets, agents are “independent” and work with more than one insurance company (usually a small number of companies); in others, agents operate exclusively – either representing a single insurance company in one geographic area or selling a single line of business for each of several companies. Agents can operate in many different forms – independent, exclusive, insurer-employed and self-employed.

Insurance Brokers

Insurance brokers typically work for the policyholder in the insurance process and act independently in relation to insurers. Brokers assist clients in the choice of their insurance by presenting them with alternatives in terms of insurers and products. Acting as “agent” for the buyer, brokers usually work with multiple companies to place coverage for their clients. Brokers obtain quotes from various insurers and guide clients in determining the adequate policy from a range of products.

In some markets, there are distinctions among brokers depending upon the types of insurance they are authorized (licensed) to intermediate – all lines of insurance, property and casualty or life/health coverage. While most, if not all, brokers are active in commercial lines, some also intermediate personal lines policies. There are also distinctions between “retail brokers,” who negotiate insurance contracts directly with consumers, and “wholesale brokers,” who negotiate insurance contracts with retail brokers and agents, but not directly with consumers.

Reinsurance brokers solicit, negotiate and sell reinsurance cessions and retrocessions on behalf of ceding insurers seeking coverage with reinsurers. Reinsurance brokers can also be involved in a reinsurer’s retrocession of parts of its risk.

As a technical matter, a broker’s role may change during an insurance transaction and over the course of an on-going relationship with a client. Many brokers sometimes act as an “agent” of the insurer and other times as a “broker” of the client when assisting a client with insuring its risk exposures through an insurance contract with a traditional carrier.

For example, the broker acts on behalf of the client when negotiating the contract of insurance and placing the policy. When the broker provides services that would otherwise be handled directly by the insurance company, such as premium payments and claims handling, the broker is essentially acting as agent for the company. This unique concept makes the insurance process more efficient for both the policyholder and the insurer.

As a practical matter, regardless of the legal role in which a broker is acting, the manner in which the broker approaches all such placements for their clients is as an intermediary

– working on behalf of their clients to facilitate the consummation of insurance contracts with carriers that have the ability and capacity to properly insure their risks.

Having said that, determining whether an intermediary is legally an agent or broker is not always clear-cut. An intermediary's status is determined by the totality of the facts regarding the specific transaction at issue. An intermediary might be called a "broker," but actually represent the insurance company in a particular transaction. In such situations, the broker is actually – and legally – considered the company's agent, not that of the customer. Although, such an activity-based approach is increasingly used around the world, the legal status of insurance intermediaries varies throughout the international insurance market. For purposes of this memorandum, included within the term "intermediary" are insurance agents, brokers, producers, advisors and consultants.

The Role of Insurance Intermediaries

As players with both broad knowledge of the insurance marketplace, including products, prices and providers, and an acute sense of the needs of insurance purchasers, intermediaries have a unique role – indeed many roles – to play in the insurance markets in particular and, more generally, in the functioning of national and international economies.

Intermediary activity benefits the overall economy at both the national and international levels: The role of insurance in the overall health of the economy is well-understood.

Without the protection from risk that insurance provides, commercial activities would slow, perhaps grinding to a halt, thus stunting or eliminating economic growth and the financial benefits to businesses and individuals that such growth provides.

The role of insurance intermediaries in the overall economy is, essentially, one of making insurance – and other risk management products – widely available, thereby increasing the positive effects of insurance generally – risk-taking, investment, provision of basic societal needs and economic growth.

There are several factors that intermediaries bring to the insurance marketplace that help to increase the availability of insurance generally:

Innovative marketing

Insurance intermediaries bring innovative marketing practices to the insurance marketplace. This deepens and broadens insurance markets by increasing consumers' awareness of the protections offered by insurance, their awareness of the multitude of insurance options, and their understanding as to how to purchase the insurance they need.

Dissemination of information to consumers

Intermediaries provide customers with the necessary information required to make educated purchases/ informed decisions. Intermediaries can explain what a consumer needs, and what the options are in terms of insurers, policies and prices. Faced with a knowledgeable client base that has multiple choices, insurers will offer policies that fit their customers' needs at competitive prices.

Dissemination of information to the marketplace

Intermediaries gather and evaluate information regarding placements, premiums and claims experience. When such knowledge is combined with an intermediary's understanding of the needs of its clients, the intermediary is well-positioned to encourage and assist in the development of new and innovative insurance products and to create markets where none have existed. In addition, dissemination of knowledge and expansion of markets within a country and internationally can help to attract more direct investment for the insurance sector and related industries.

Sound competition

Increased consumer knowledge ultimately helps increase the demand for insurance and improve insurance take-up rates. Increased utilization of insurance allows producers of goods and services to make the most of their risk management budgets and take advantage of a more competitive financial climate, boosting economic growth.

Spread insurers' risks

Quality of business is important to all insurers for a number of reasons including profitability, regulatory compliance, and, ultimately, financial survival. Insurance companies need to make sure the risks they cover are insurable – and spread these risks appropriately – so they are not susceptible to catastrophic losses.

Intermediaries help insurers in the difficult task of spreading the risks in their portfolio. Intermediaries work with multiple insurers, a variety of clients, and, in many cases, in a broad geographical spread. They help carriers spread the risks in their portfolios according to industry, geography, volume, line of insurance and other factors. This helps insurers from becoming over-exposed in a particular region or a particular type of risk, thus freeing precious resources for use elsewhere.

Reducing costs

By helping to reduce costs for insurers, broker services also reduce the insurance costs of all undertakings in a country or economy. Because insurance is an essential expense for all businesses, a reduction in prices can have a large impact on the general economy, improving the overall competitive position of the particular market.

Of course, the insurance cycle of "hard" and "soft" markets can have a significant impact on the benefits – both good and bad – of increased availability. Generally, however, increased availability benefits the consumer by leading to product competition, price competition, and improved services. By reducing insurance costs across markets, intermediaries make an important contribution to improving the economic conditions in a country.

Insurance intermediation in practice

The intermediary's role within this enterprise stems from two essential functions performed by the intermediary: reducing search costs and uncertainty ..

Search costs

Intermediaries reduce the search costs to insurance buyers looking for the right coverage and the right insurer for their risks, and they reduce sales and marketing costs to insurance companies in search of insurance buyers.

Intermediaries know the insurance marketplace. They know their clients' risks; they know the insurers willing to cover those risks; and they know the best way to secure that coverage.

Uncertainty

Insurance purchasers and companies do not have all the information relevant to the placement of a policy, which makes it difficult to negotiate a fair price and the proper terms and conditions of a policy. Purchasers know the risks in need of coverage, but may not know the financial health of the insurer or the prevailing conditions of the insurance market. Insurers, on the other hand, may have all the company and market financial information necessary to make a decision, but are not in a position to know enough about the risk and the prospective client.

Intermediaries know the insurance marketplace, they solicit and provide information on insurance purchasers and companies, and they make the information more easily understood to both parties to a transaction.

In the interest of long-term client and insurer relations, brokers have a strong incentive to ensure that all parties have the information they need so as they are able to enter into a mutually beneficial arrangement.

Insurance purchasers and companies may come to a transaction with unequal bargaining power. A small- or medium-sized insured may come to a transaction with significantly less clout than the large insurer with whom they need to do business. An intermediary is often able to balance the equation by leveraging its business volume with carriers, and thereby obtain better terms and conditions for the client."

Every carrier essentially offers the same promise – to compensate the insured for a loss.

To make that promise meaningful, however, the carrier must have the ability to properly understand and evaluate the risk presented and the capacity and financial solvency required to pay any claims that may result from that risk, as well as a reputation that suggests a willingness to make good on that promise.

There are literally thousands of insurance carriers, from large national carriers that offer a broad range of coverages to small regional carriers that may specialize in a single product line. For most clients, coverage terms must be solicited from and negotiated with the carriers on a case-by-case basis.

Clearly, numbers dictate that this cannot be done with every carrier in the marketplace that has the capacity to insure a given exposure. Clients rely on intermediaries to know a universe of carriers that are well-situated to address their needs and negotiate with selected companies to obtain the relatively best overall insurance value for them.

To do this, the development of a relationship between intermediary and carrier is essential. In order to provide products and services to their clients, intermediaries must have expertise with the risk profiles presented by their clients and the savvy to go to the right place for the right coverage for each risk profile.

The best way for an intermediary to evaluate a carrier's ability to insure a risk and its capacity to pay claims is by working with that carrier over time. Similarly, a carrier will be in a much better position to understand and evaluate the risk presented if it understands and trusts the intermediary presenting the risk to be insured.

Intermediaries are valued by insureds and insurers as an essential element of the insurance marketplace.

Intermediaries search the insurance marketplace to find and place coverage for their clients' risks. They also assist clients in the development of alternative risk transfer mechanisms for risks that otherwise would be impossible – or prohibitively expensive – to insure, and they provide services to both insureds and insurers.

In today's complex insurance marketplace, however, intermediaries have become more than middlemen between insurance companies and insurance buyers.

They bring experience and expertise to the insurance marketplace, using their knowledge of the insurance markets, their familiarity with their clients and clients' risk, and their access to insurers forged through long-term relationships, to sell and service insurance coverage for costly, and in many cases unique, risks.

Commercial insurance clients are generally professional risk managers. As sophisticated insurance purchasers, they realize that commercial insurance products are not commodities; rather, they are customized risk transfer tools, the price and terms of which are generally negotiated on a case-by-case basis.

Placement of such risks can be a long and difficult process. Sophisticated commercial purchasers rely on their intermediary to fully understand and appreciate their insurance coverage needs and to find the coverages suited to address those needs.

Intermediaries and Risk management

Risk managers increasingly use enterprise risk management tools to allow them to understand their risk profile, identify cost drivers and analyze enterprise-wide risk. Some intermediaries are active in providing such tools.

One of the functions of some insurance intermediaries is to help clients manage their risks, improving their risk profiles and reducing the likelihood that an insured event will occur.

Not all risks must be accepted as they are. When properly managed, risks can be controlled and minimized. Some can be avoided; others can be modified to limit their frequency or financial consequences.

Risk management is the process of analyzing possible exposure to loss, reducing loss potential, and protecting financial assets. Businesses often look to their intermediary to act as consultants on risk management and advise them on the best ways to mitigate risk.

Some intermediaries therefore represent their clients in all phases of the risk management process: helping clients evaluate risk exposures; implementing measures to minimize such exposures; identifying and facilitating the purchase of insurance products or risks management systems best suited to a client’s insurance needs; and managing the claims process.

There are many ways to protect financial assets. Purchase of insurance is the traditional way to transfer risk, but there are other methods that intermediaries and their clients use to ameliorate risks. Use of alternative risk transfer mechanisms – such as forming a captive insurance company, accepting higher insurance deductibles, or setting up reserves to pay losses – is an example.

Self-insurance

Self-insurance can take many forms. Policyholders can assume higher deductibles or accept lower amounts of insurance coverage. Self-insurance programs, however, must be carefully balanced with a well-managed loss control program to minimize the exposure a business faces and to protect third parties that are injured. That is where skilled intermediaries come in – to act as consultants in designing programs.

Captives

Creating a captive insurance company is a popular risk-financing alternative, especially when insurance costs are high. Captives are also popular options for commercial enterprises that want to finance and control their risks.

A captive insurer is an insurance company that is wholly owned by a non-insurance organization, typically a large company or group of companies in the same business. An intermediary may help a client to establish a captive and/or manage the captive once it is up and running.

A captive's primary purpose is to insure or reinsure the risks of the parent organization, but they can also cover risks of non-related parties. A well-run captive can provide insurance coverage at lower rates than are generally available in the traditional insurance marketplace. Captives rely on reinsurance to spread the risk, just as traditional underwriters do.

Risk management involves far more complexity than the simple purchase of insurance. A large part of the task is preventing risk in the first place. Some Insurance Intermediaries are skilled in the art of working with their corporate clients in analyzing and controlling risk, setting up safety programs and other risk control techniques, and arranging alternative risk transfer mechanisms, as necessary.

These activities and services are beyond those typically associated with the placement and servicing of a policy contract, and have contributed to the evolution of intermediaries from their role as providers of basic brokerage services into full-service intermediaries, providing not only strict intermediation services, but a wide variety of fee-based risk management and consulting services, as well