Policies on parade

MICHAEL CLAYDON EXPLAINS HOW TO CONDUCT AN INSURANCE PROGRAMME REVIEW.

Increasingly drawn into the corporate purchase of insurance, treasurers have brought with them greater analytical rigour to decision-making on the extent and level of risk transfer and the selection of counterparties. Nowadays the corporate treasurer often deals with the purchase of non-employee related insurance (typically administered by an insurance or risk management department). And to comply with the Combined Code, the FD or the treasurer presents an annual report to the board describing significant insurable risks and the extent to which the corporate insurance programme addresses these. Governance has also led to more regular reviews of broker services and the insurance programme, and it is now common for a tender process to be undertaken every three to five years.

THE TENDER PROCESS Insurance brokers figure large in the corporate purchase of insurance policies. A fundamental part of their role is to solicit tenders from insurers and to advise on which is the best. However, from the company's perspective, the main "drains up" review of insurance and risk management strategy tends to be conflated into an insurance broker review. One of the main criteria in a review of competing insurance brokers will be their view as to the best strategy and optimal insurance programme. These reviews are the subject of this article.

In many companies the procurement team helps drive the tender. Insurance brokers have traditionally relied on long-term and close relationships and have had an uncomfortable time with procurement's relentless focus on process and cost and unsentimental view of history.

Before embarking on the process of an insurance review, it is important to consider carefully what you value. For example:

- What do you want your insurance programme to do? Is it to protect cashflow or earnings per share (and, if so, what are the acceptable limits?), say, or to offer a claim handling service?
- How will you evaluate and cost proposals for higher or lower levels of self-insurance (e.g. cost of capital to support higher levels of retained risk)?
- Are there major risks that are not currently insured but which could be?
- What attributes and services of your insurance broker do you value and are willing to pay for?

WHO TO INCLUDE? Competing brokers will invariably maintain contacts, both professionally and socially, with a prospective client, proffering their services and enquiring solicitously when the next review is to take place. Naturally, they expect to be included. There will be no shortage of supplicants, so there is a temptation for a company to permit a large number of bidders, but preselection is advisable to keep the process manageable.

In a report on the UK audit market, consultancy Oxera listed the determinants of client choice as reputation, international coverage, sector-specific skills and quality of staff. These attributes are just as appropriate in deciding which insurance brokers to put in your review.

It is important for a company to demonstrate that its intent is serious and its process fair. If brokers sense that it is merely an exercise and there is no realistic likelihood of replacing the incumbent, their response is likely to be half-hearted.

THE TENDER DOCUMENT This must define your objectives. Be clear what it is you are seeking to address. A typical aim is to benchmark existing broker services against what is available in the broker community. You should indicate what you value and where you would be interested in other services. Another common aim is to review the current risk transfer programme in terms of structure, coverage and cost against what is available in the market and your financial appetite for risk.

The tender should indicate its scope. Say what is included in it – and what is not. Describe your requirements and expectations. You may wish to reveal some or all of any scoring matrix that you are using. Be clear whether any approach to the insurance market is permitted. This can be dangerous, and purely conceptual reviews and pricing are normally preferred.

Specify that the bid is to be made at no cost to your company. Also reserve the right to appoint more than one broker.

An information pack should also accompany the tender document, which may be subject to a confidentiality agreement. If conceptual pricings are required from competing brokers, the information pack must include all the technical underwriting information they require. Copies of the most recent underwriting submissions to the insurance market can be a good way of shortcircuiting this.

The information pack should also contain sufficient information to give competing brokers a clear picture of your financials, culture, management structure, business strategy, etc.

WRITTEN PROPOSALS Request proposals under these headings:

■ **Risk transfer** There should be a critical review of the current risk transfer programme, and suggestions for an alternative approach should include estimated costings and proposed counterparties.

■ **Service** Details should be provided of the insurance broker's service team, their roles, responsibilities, geographic location and qualifications. A structure chart with communication procedures should be included.

■ **Technical and specialist services** The proposals should provide details of such services as risk management, claims management and captive insurance company management.

■ **Financial security** They should specify how the financial security of counterparties is established, monitored and communicated.

■ **Remuneration** An annual fee should be specified for the provision of all services included in the brief. Insist on full transparency of market-derived income, including brokerage and commissions (including reinsurance), work transfer fees, and insurance market placement agreement. You might ask for a three-year proposal if you are contemplating a three-year broker appointment. A performance element could also be included.

■ **Timescale** Allow between 60 and 90 days for the tender process. Lay out milestones from the date of issuing the tender to communicating the decision. Include within this time for Q&A sessions with the bidders. Be prepared to engage with the bidders throughout the process.

■ **References** Ask for references from clients of a comparable size and geographic spread.

■ **The review team** It is usual to have a team to review the tenders. It will incorporate treasury/risk management and procurement, and it may be appropriate to include representatives from the business too. If consultants have been engaged to help manage the bid then they should also be part of the evaluation process.

■ **Conclusion** The bid process lets companies leverage the ferocious competition between brokers and the enduring soft pricing in the insurance market. Material cost reductions are invariably achieved, as are qualitative improvements in the programme.

When discussing remuneration and risk transfer pricing with your broker, bear in mind the words of John C Bogle, founder of investment company Vanguard Group: "There is too much cost in the industry and not nearly enough value; too much speculation and too much complexity. There is also too much salesmanship and not enough stewardship." He was talking about the fund management industry, but his words are just as appropriate for the insurance industry.

Auditors and insurance brokers compared

The market for auditing the FTSE 350 companies is dominated by the Big Four firms: Deloitte, Ernst & Young, KPMG and PwC. The Big Four audit 99% of the FTSE 100 and 95% of the FTSE 250. This situation, brought about by a combination of mergers since 1989 and the demise of Arthur Andersen in 2002, has caused disquiet for some time.

It is instructive to contrast the Big Four's market penetration with the insurance broking's equivalent: Marsh, Aon and Willis – let's call them the Big Three. All three are listed on the New York Stock Exchange, and have market caps of around $13.5bn, $11.5bn and $5.5bn respectively. While London-listed Jardine Lloyd Thompson may be aggrieved at not being part of a Big Four, its market cap is around one third of Willis's and it does not have a global network equivalent to the Big Three's.

Direct comparison between auditors and insurance brokers on market share is not straightforward. Information on insurance brokers is not readily available, and insurance broker mandates are sometimes shared (although there is generally a lead broker).

However, marketplace data makes it clear that the Big Three act for over 85% of the FTSE 100. They also have a strong position in the FTSE 250, although firms such as Jardine Lloyd Thompson, Lockton and Heath Lambert offer more of a challenge here.

However, the Big Three do not enjoy the oligopolistic rewards which accrue to the Big Four. The reason for this is threefold.

First, audits are rarely put out to tender, and even when they are, switching rates are low. By contrast, insurance broker reviews are regularly undertaken, typically every three to five years, and mandates change often.

Second, there is little pressure on auditors' fees, while competitive tendering has relentlessly driven down the fee levels of insurance brokers. This, coupled with the miserly investment returns on fiduciary funds, has led brokers to seek revenues from insurers – a controversial topic.

Third, through their board-level audit relationship, the Big Four can pitch for other lucrative work in areas such as tax and corporate finance. Insurance brokers market services such as risk advice and claims management, which tend to be low margin.

There is significant market concentration in the field of insurance broking and it is difficult to see how this will change. The competitive landscape is rather different, though, to that of audit, and it is unlikely that the chairmen of Marsh, Aon and Willis will be required to explain themselves to the House of Lords Economic Affairs Committee, as has recently been the case for the audit industry.

Michael Claydon is the founder and CEO of Michael Claydon Consulting.
michael@claydonconsulting.com
www.claydonconsulting.com