An honest bargain

MICHAEL CLAYDON LAYS DOWN THE GROUNDRULES FOR CORPORATES IN NEGOTIATING AN INSURANCE BROKER'S FEE.

In the April edition of The Treasurer, the first part of this feature on dealing with insurance brokers (Policies on Parade) mentioned how the latter's proposals for providing a company's insurance package should cover remuneration. Once you have selected your broker, you will have to get down to the business of negotiating that remuneration.

The first rule is to come to an agreement at the very start of the appointment and not let it drift to a point where the broker has already started working for you.

The second rule is to require your broker to disclose and quantify all remuneration they receive from insurers including:

- brokerage/commissions both directly and from reinsurance which is related to your business;
- work transfer payments;
- engineering/risk management fees;
- profit commissions; and
- market placement facilities.

Take all of these into account when negotiating the fee.

AIRMIC, the insurance buyer's trade association, provides advice to its members. Its guiding principle is "transparency and full disclosure of financial and other interests".

Historically, brokers earned commissions, but over time larger clients have moved mainly to fee-based remuneration. Brokers have found the transition from commission to fees challenging and even to this day find it difficult both to differentiate their offerings and to articulate value. They generally lack conviction when discussing remuneration with a client.

Responsibility for agreeing fees will usually fall to the individual in the broking business responsible for managing the client relationship. This individual will typically approach the task in the light of agonised internal discussions and the loud demands of individual profit centres for "our share". It is probable that from some higher level in the organisation, he or she will likewise have been exhorted to be robust in the negotiations.

So how do you negotiate a fee with your broker? The start point should be establishing the scope of services, which should be documented in a formal contractual service agreement. Where the broker appointment was made following a tender, this should have been part of the process. The remuneration terms should be included in the service agreement.

To bring some rigour to the discussions, and to enable you to understand exactly what it is that you are paying for, ask your broker to disaggregate the pricing between major components of the insurance, which can include:

- programme design;
- market placing;
- day to day service to head office and to the subsidiaries both domestically and through their global network;
- information gathering;
- risk surveys; and
- claims management.

Breaking it down in this way enables you to interrogate the value which you are receiving for each component of the services. You might also ask the broker what profit margin they aspire to and then form a view as to its reasonableness.

Consider introducing a performance element to the fee. You will have selected your broker following a number of assertions they have made – achievable pricing may be one. It is not unknown for brokers to over-egg their claims to the point of recklessness in order to obtain the contract. A performance clause would give them the agreed fee if they achieve what they promise, reward them with a bonus if they outperform, and impose fee clawbacks if they fall short.

Make sure that quarterly payment of fees is included in the agreement. This helps your cashflow and authorising payment provides a useful reminder to review delivery against what was promised.

Setting the criteria in the year of a broker appointment following a competitive review is a fairly straightforward activity. In subsequent years it is more difficult because an incumbent broker will have intimate knowledge of prevailing market conditions and thus be tempted to set performance criteria that they are confident of achieving.

Having agreed the fee for whatever

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period of time, the day will come when it expires. The techniques described earlier should guide fee renegotiation.

There is a strong probability that an incumbent broker will ask for the fee to be increased. This request may be accompanied by a well-reasoned proposition. It might equally take the form of a litany of self-praise or even no justification whatsoever beyond some mumbling about inflation.

Insurance brokers regard fees and commissions paid by clients as a form of annuity. The longer they have a client, the more profitable that client becomes. Retention is the industry's Holy Grail.

REVENUE STRESS Brokers' income has been under severe strain for a number of reasons, including the effective elimination of traditional commissions and its replacement by fees, the savage competition on fees between brokers, a low interest rate environment hollowing out investment income, and the depredations of clients' procurement teams. Brokers have therefore turned to the insurance market to provide additional revenue streams.

Brokers commonly get the insurer to pay a percentage of the premium on each transaction – typically a range of 2.5–3.5% – in exchange for the services the broker is supposedly giving them. Clients are often unhappy with this arrangement (should it come to light) and insist on some or all of the amounts generated being handed over to them. There is also ambiguity as to who is bearing this percentage of the premium – the insurer or the client. There is a move by some brokers to translate these amounts to a portfolio rather than a transactional basis, obscuring the disclosure issue.

Another recent development has been for the broker to ask insurers for an annual payment – usually several hundreds of thousands of pounds, and certainly millions on a global basis – in exchange for services such as market intelligence, access to clients, new business opportunities and joint marketing initiatives.

Market-derived income is a controversial issue and one where the participants are reluctant to go on the record. Robert Hiscox of the eponymous Hiscox is a notable exception. His chairman's statement accompanying the 2010 results includes a forthright view that brokers should look to their clients for adequate fees and not put pressure on insurers to make up a deficiency.

Payments to brokers that are unrelated to transactions present a regulatory and legal challenge to insurers since they have to demonstrate they are receiving value for service and not participating in a "pay to play" scenario. Brokers for their part have a contractual duty to the client to exercise reasonable skill and care in advising on and placing insurance. They will be in breach of that duty if they either obtain secret commissions or refuse to deal with an insurer that will not give them extra remuneration should that insurer be prepared to provide the broker's client with the most appropriate cover at an acceptable price.

Bringing rigour to the fee discussion and insisting on transparency does not mean you have to be in conflict with your broker. But beware the tendency of your procurement team to evaluate what your insurance broker brings as if they were buying paper clips. Recognise the value that an insurance broker can bring, treat them as a trusted adviser and pay them accordingly.

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