EVERYTHING TO LOSE

IT IS BEST PRACTICE TO REGULARLY REVIEW THE CORPORATE INSURANCE PROGRAMME. MICHAEL CLAYDON EXPLAINS WHY

Most companies, as a matter of best practice, undertake a thorough 'drains-up' review of their insurance programme on a rolling three- or five-year basis. Often this takes the form of a competitive broker review. A regular review takes place for the following four reasons:

1. The risks facing the company change

One would expect changes in activity to be considered in the annual insurance renewal review. But it is good practice, on a periodic basis, to step back and look at the company's risk profile overall and the extent to which it has, or will, change. New risks that can arise or increase over time include cyber risks, IT dependencies, obligations on directors, political and counterparty risks, risks associated with operations in new territories and supply chain dependencies.

2. The company's level of risk tolerance changes

The company can choose to retain insurable risk either by not insuring (because the insurance option is not attractive) or by accepting a self-insured retention or a deductible. It is important that these retained risks are understood and quantified. What level is appropriate will depend on:

- The robustness of the company's balance sheet and cash flow in relation to shareholders' expectations; and
- The price of insuring at any particular level and whether it is sensible expenditure in respect of risks that could be assumed.

While the annual review at renewal time may address the company's level of risk tolerance, the process tends to build upon the existing framework and generally within the constraints of assumed parameters.

3. The insurance market changes

The cyclical nature of the insurance market results in volatility of pricing, capacity, levels and breadth of coverage. New insurers periodically enter the market while others will exit. The insurance programme structure should be tested regularly to ensure its suitability in current and anticipated future insurance market conditions.

4. Corporate governance

The *UK Corporate Governance Code* (formerly the *Combined Code*) states that the board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets. In most listed companies, oversight is provided through a board audit and risk committee.

The London Stock Exchange's guide to corporate governance, published in September 2012, divides risks into four main categories: financial, operational, hazard and strategic. In relation to insurable risk, which generally falls within operational and hazard risks, an audit and risk committee will want to look beyond the traditional review process described

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above and will regularly expect confirmation that the insurance programme reflects:

a) The identified and quantified risks to which the business is exposed;
b) The articulated risk appetite and loss tolerance limits; and
c) Counterparty policy.

The role of the treasurer

There has been a trend over recent years for the purchase of non-employee-related insurance, typically administered by an insurance or risk management department, to come within the remit of the treasurer. This has resulted in greater analytical rigour being brought to bear in areas such as the extent and level of risk transfer and the selection of counterparties.

The treasurer may also be required to present an annual report to the board describing significant insurable risks and the extent to which the insurance programme addresses these.

The relationship with the company's insurance broker is also likely to come within the treasurer's remit. Most corporate buyers will have a periodic review of their insurance broking arrangements and typically this takes the form of tendering the business to a number of firms, usually the incumbent and two or three competitors. A review may also be undertaken outside of the regular cycle if there is dissatisfaction with the incumbent's performance.

While a review is often cost-driven, it can also produce useful ideas on risk management and financing options from competing brokers who, in their anxiety to impress, will often give away their intellectual property.

An independent approach?

An insurance broker tender is a well-established mechanism for reviewing the insurance programme and corporate clients will often engage a consultant to help them manage the process. More recently, clients have started to eschew a broker tender in favour of having a consultant undertake an audit of the insurance programme to bring a dispassionate perspective. This approach is generally speedier, less costly and avoids disruption. While there is not a central database of consultants, your broker will be able to provide you with a list of suitable firms.

Conclusion

There are a variety of ways to review the corporate insurance programme: in-house audit; peer review by the incumbent broker; full-scale broker review; and external audit. What is undeniable is that it is best practice to conduct such a review on a regular basis.

HOW TO CONDUCT A BROKER REVIEW

1. Decide which brokers to include in the review. 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 names to include in an insurance broker review.

2. Produce a tender document. This should define your objectives, making it clear what you are seeking to achieve. A typical aim is to benchmark existing broker 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.

3. Provide an information pack. This should be part of the tender document and made the subject of a confidentiality agreement. If conceptual pricings are required, and this is usual, the pack must include technical underwriting information. Providing copies of the most recent underwriting submissions to the insurance market will short-circuit the process. The pack should also contain sufficient information to provide competing brokers with a clear picture of the company's operations, financials, management structure and business strategy. Be prepared to engage with the bidders, which is often accomplished through a Q&A meeting.

4. Ask for written proposals. Request proposals under these headings:
RISK TRANSFER There should be a critical review of the current risk-transfer programme, with suggestions for an alternative approach that should include estimated pricing and proposed counterparties.
SPECIALIST SERVICES The proposals should include details of specialist services such as risk management, claims handling and captive insurance company capabilities.
SERVICE Details should be provided on the service team, showing roles, responsibilities, qualifications and experience together with a structure chart.
FINANCIAL SECURITY The proposals should specify how the financial security of counterparties is determined, monitored and communicated.
REMUNERATION It would take an entire article to do justice to an area that has traditionally been characterised by opaqueness and obfuscation and one in which conflicts of interest abound. While brokers display imagination in their remuneration models, they have not yet resorted to aping lawyers in charging for photocopying or adopted the practice of investment banks in charging asset managers for access to their corporate clients.

An annual fee should be specified for the provision of all services in the brief and broken down by major area of work, for example, placing, service visits, claims management. Insist on full transparency of market-derived income including brokerage and commissions, work transfer fees and payments received through placement and service agreements.

During the course of negotiations, it may be stated that risk-transfer costs are unaffected by market-derived payments received by brokers. The reality is that insurers factor these payments into their pricing models.

If an appointment of greater than one year is contemplated, then the remuneration proposal should address this. Fees in year two and beyond should reflect the non-recurring nature of some activities, such as the need for extensive market interaction in multi-year insurance programmes.

5. Establish a review team. It is usual to establish a review team to evaluate the tenders, with membership drawn typically from treasury, risk management and procurement. It may be appropriate to include representatives from the business, particularly if they are the end users of the broker's services.

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