

Wholesale-nomics

An analysis of the value and economics of the wholesale insurance brokerage practice.

Abstract: Including a professional wholesale broker on the placement team improves the economics of the insurance transaction, yielding the most favorable coverage for insurance buyers and driving sustainable growth for retail brokers.



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Executive Summary

Since the 19th century, producers of goods have relied on wholesalers to distribute their products. The system works because it is an efficient method for manufacturers to place products on the shelves of retailers and, ultimately, in the hands of consumers. Wholesalers level the playing field and enhance both competition and growth opportunities for small and mid-size retailers by providing access to the same products that are available to larger competitors.

In some respects, the role of the wholesale insurance broker is no different. Wholesale insurance brokers offer an effective vehicle for insurance carriers—the manufacturers—to distribute their products. However, in today's increasingly complex risk landscape, wholesale insurance brokers are much more than product distributors. They are knowledgeable placement specialists who, collaborating as a team with retail brokers and insureds, offer the advantage of deep expertise in particular lines or classes of business, sophisticated technology to evaluate risks, and access to markets that would otherwise be out of reach.

Insurance brokers play a valuable role helping their clients assess, manage and transfer risks. The commercial insurance retail broker is similar, in some ways, to a cardiologist who consults with other specialists to ensure their customers get the best quality care, especially in complex, unusual or time-sensitive situations. Retail brokers who may be unwilling to call in a specialist—the wholesale broker—could be denying their clients the best available expertise and coverage by limiting opportunities to form partnerships and explore all available options on the insured's behalf.¹

Retail brokers may be limited to placing insurance through admitted carriers operating in states in which the retailer is licensed. Admitted carriers are subject to state regulation of the policy forms they use and rates they charge, which at times can restrict flexibility and creativity for high-hazard, unusual or distressed risks. Carriers that specialize in this type of coverage typically choose to operate in the surplus lines market where they are free to tailor coverage to the needs of each insured.

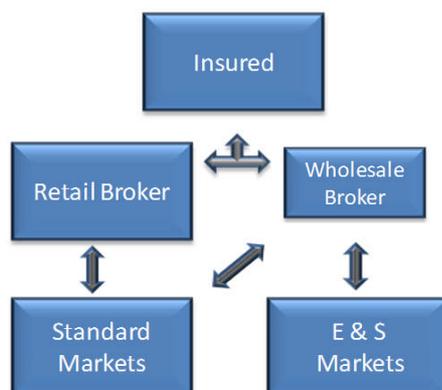
Surplus lines insurers (also called excess and surplus lines insurers) rely on the technical expertise of wholesale placement specialists to match them with appropriate risks after a thorough assessment. In the case of property insurance, even an account without catastrophe exposures but with a poor loss history may require the expertise and market intelligence of a wholesale broker to find a carrier with an appetite for that business and to structure a deductible or retention arrangement to maximize coverage at a minimum price.

¹ There are two types of wholesale brokers. This white paper focuses on the type known as a surplus lines broker. A surplus lines broker places insurance in the non-admitted market on behalf of a retail broker, but does not have binding underwriting authority from any carrier and is thus independent to seek the best alternative for its customers. The other type of wholesaler, the managing general agent, has binding underwriting authority from the carriers it represents.

This analysis describes the role of wholesale brokers and the value they bring when working as a team with retail brokers and insureds. It suggests that retail brokers can improve their retention of existing clients and compete more effectively for new ones by introducing a wholesale insurance broker into the client relationship. It also describes how the compensation model of wholesale brokers does not increase costs.

This is a volatile period for the insurance industry. Trends like globalization, specialization and increased transparency are changing insurance buying habits, and that, in turn, is driving a shift in insurance distribution channels. While the idea of involving a specialist in complex insurance transactions is nothing new, wholesale brokers no longer operate behind the scenes like the wizard behind the curtain. Corporate executives today are demanding information and accountability from brokers and exerting more control over their insurance programs. They recognize that pursuing the most efficient path to success requires a tightly knit team of high-performance specialists who employ best practices for every case.

In the effort to exercise greater control in evaluating and mitigating their risk, more risk managers elect to appoint the wholesale broker of their choice to consult on every placement, and when appropriate, to represent their account to the excess and surplus and specialty markets. As consolidation among retail brokers upends established relationships, some risk managers have a trusted wholesale broker undertake all of the marketing functions for their account; otherwise, they have the wholesale broker market the account in coordination with their retail broker. This frees the retail broker to concentrate on other account services. A synchronized distribution might look like this:



By establishing the right partnership, retail brokers will find that their clients have less need to seek the offerings of competing brokerages. Similarly, in situations where a new retailer is bidding against the incumbent retailer, a professional wholesale broker can provide the capabilities and expertise needed to identify and improve upon the weaknesses of either program.

Working in concert with the retail broker and the insured, the wholesale broker can develop and organize the data to prepare the best possible submission to the market, liberating a retailer's time and resources to concentrate on direct account servicing and production. A

professional wholesale broker on the placement team improves the economics of the insurance transaction. Maximizing the joint efforts of both retailer and wholesaler yields the most favorable coverage and cost for insurance buyers. Such cooperation reinforces the insured and retail broker relationship through superior overall service.

The remainder of this study will look further into the role of insurance intermediaries, the specific skills and value a wholesale broker brings to the placement process, and the economics of using a wholesale broker.

Role of the Insurance Intermediary

Most commercial property-casualty insurance is placed by independent insurance brokers. In “The Economics of Insurance Intermediaries,” authors J. David Cummins and Neil A. Doherty, professors at the Wharton School of the University of Pennsylvania, describe the role and the value that brokers bring to the insurance transaction as “market makers.”

- They advise buyers on their insurance needs and design insurance programs.
- They survey the market and match buyers with the specific insurers that exhibit the skill, capacity, risk appetite and financial strength to underwrite the risk.
- They help buyers select from competing offers based on a combination of factors, including price, breadth of coverage, risk management services, reputation for claims settlement and financial strength.
- They provide important underwriting information to insurers to help them evaluate the risk.
- On very large risks, brokers often engage in a complex process of designing a layered insurance program and coordinating negotiations so that different insurers can subscribe to varying levels of risk.

Smaller niche and regional brokers that need technical capabilities or access to some underwriting facilities can compete effectively in their markets against larger brokers when they collaborate with specialist providers to deliver a comparable range of sophisticated services. For a variety of reasons—including excellent service and longstanding relationships—many risk managers prefer to work with smaller or regional brokers. Wholesale brokers are the specialist providers that enable these brokers to retain clients whose insurance needs grow more complex. In other circumstances, risk managers draw on the expertise of wholesale brokers to further complement the services of the large global brokers. In either case, with a wholesale broker providing additional services, insureds receive the best of both worlds: the unique or personal services of a smaller firm, coupled with unrestricted global access to specialized markets and services; or the enhanced expertise of the wholesale broker in tandem with the services of the global retailers.

The Wholesale Difference

The relationship between retail brokers and wholesale brokers has been evolving over time from one of independence to interdependence. In an effort to streamline marketing and risk selection, some specialty insurers restrict access to their capacity to specific wholesale brokers. Retail brokers, likewise, recognize that a wholesale broker can provide necessary expertise in a particular industry, class of business, or type of exposure.

In establishing a partnership with a wholesale broker, retailers gain advantages that greatly enhance the value that they offer their clients. In addition to access to a larger variety of insurers with greater capacity, the retail broker can tap the superior market knowledge of a placement specialist. Many wholesale insurance brokers have access to standard carriers and reinsurers in addition to non-admitted carriers. These insurers rely on the expertise of wholesale brokers to bring them appropriate risks and to provide the technical underwriting information that is necessary for them to consider and write those risks.

Wholesale brokers who are experts in their field know exactly what information underwriters need to make sound underwriting decisions, obtain capacity effectively, and, ultimately, communicate results to their partners knowledgeably. Deep industry expertise, as well as broad marketing reach, will generally produce the most favorable policy terms and conditions available, while minimizing cost. Specialized hard-to-place risks—such as high earthquake, flood or hurricane exposures—will benefit from increased competition created by marketing to additional and diverse carriers. On large, complex accounts requiring multiple insurers, wholesale brokers can be instrumental in program design, having the ability and expertise to syndicate among many insurers, ensuring consistency and eliminating gaps in coverage.

A strategic partnership with a wholesaler enables the retail broker to solidify a strong relationship with existing clients while freeing up internal resources to attract new clients. In this way, it can be an important driver in the long-term, sustainable growth of an agency.

In the following sections, we use the example of a wholesale property broker to illustrate in more detail the value-added services that a wholesale broker offers the placement team.

Evaluation of Risk and Exposures

The first step in the successful placement of a commercial insurance program is to evaluate and identify the client's coverage needs based on their risks and exposures.

A knowledgeable broker helps risk managers and other insurance buyers identify the level and types of coverage needed, and explains exactly what they are purchasing in a given policy. For large, complex or unusual risks, wholesale brokers provide necessary assistance in identifying and quantifying an insured's risks and exposures.

In the case of property catastrophe exposures, the professional wholesaler uses analytical tools to help insureds achieve a better understanding of their probabilistic risk of loss. For example, wholesale brokers may offer mapping tools that accurately and efficiently break down and identify an insured's aggregated exposures in particular geographic areas. Furthermore, probabilistic catastrophe models help to quickly identify an individual insured's exposure to catastrophic loss through the use of statistical analysis and scientific event data. By using these analytical tools, wholesale brokers enable insureds to better understand their exposures and make more informed choices about their tolerance for retaining risk versus the costs of transferring their risk. This provides insureds with a method to establish their required and acceptable coverage limits and deductibles. This information may also help reduce demanding lender insurance requirements.

These sophisticated risk analysis tools allow brokers to negotiate more effectively with underwriters by putting them on equal footing. With this information, brokers are better able to anticipate underwriter and insurer concerns and structure an insurance program around them. Armed with a comprehensive analysis of the insured's exposures and the required coverages, limits and deductibles, it is then possible to compile, streamline and tailor relevant risk data for submission to the underwriting community.

Furthermore, wholesalers may also have the ability to benchmark the insured's program against other programs and exposures that may be similar. Benchmarking could include pricing, deductibles and coverage sublimits.

Preparation of the Submission

Insurers depend on accurate information to properly evaluate, underwrite and price risk, yet a common complaint among underwriters is that they receive incomplete, illegible and inefficient submissions. When insurers feel the information is incomplete or suspect, they will offer uncompetitive pricing or decline to quote. When fewer companies are willing to quote, competition for the account is diminished, decreasing the likelihood that the insured will be able to obtain the broadest possible coverage at the lowest cost.

A well-organized and thoroughly documented submission will help overcome the first hurdle: getting the underwriter's attention. This is especially challenging in a hard market, when prices are high, capacity is limited and underwriters are inundated with submissions. For the most challenging risks, however, the market cycle is irrelevant.

Wholesale brokers who are experts in their field and know exactly what underwriters need to make a confident evaluation and sound underwriting decision: high-quality, detailed and complete risk data presented in an organized fashion.

Market Intelligence and Market Access

The placement process for commercial insurance accounts requires a comprehensive understanding of the global insurance marketplace, evolving risk appetites, preferred layer positioning (primary, buffer, excess, etc.) and financial strength in order to develop the best program design.

A placement team that combines the power of a retail and wholesale broker provides the insured undeniable advantages: in-depth knowledge, broad market reach throughout the global marketplace, strong relationships with underwriters, and familiarity with the insured's needs. During adverse or hard market conditions—when prices increase because of reduced capacity—a wholesale broker can be a critical partner in navigating the market to find the capacity to cover the risk while mitigating some of the higher insurance costs.

For accounts that are too large or complex to be handled by a single company, the placement team can pinpoint and position multiple insurers willing to assume various “pieces” of the coverage to be placed. Having access to all the markets results in increased competition for the insured's business, and increased competition results in lower pricing and better coverage terms.

Developing the most effective program design at the lowest cost requires an elaborate process of coordination and negotiation. The placement team will scrutinize the insurance marketplace and match the program exposures with companies that have the ability, expertise, capacity and desire to underwrite such risk. While price is important to buyers, it is only one among several criteria in evaluating competing offers from insurers. The breadth of the coverage offered and the insurers' financial strength, as well as their track record on claims settlements are also very important. Risk management and engineering services can be an important consideration for some insureds, especially for those with complicated manufacturing operations.

Claims Assistance

Members of the placement team are effective advocates for policyholders in claims settlement situations with insurers. If the wholesale broker has placed the business, it has detailed knowledge of the carrier and the coverage and a vested interest in resolving the claim to the client's satisfaction. A wholesale broker assists in the development and tailoring of claims-handling instructions in concert with the retailer to manage the claims process proactively. By partnering with the retail broker's claims staff, support is added to assist in coordinating and directing the claims team in large or difficult claims situations, as well as managing the information flow, providing necessary documentation to authenticate the claim, and referring any additional experts when necessary. In summary, this is an added value utilized to mitigate the claims process and enhance the experience for the insured during a critical time of the overall business process.

Post-Binding Services

Outstanding service does not end on the binding date. The placement team prepares and presents a comprehensive insurance proposal upon concluding market negotiations, followed by thorough confirmations of insurance for new and renewal business to the insured. Wholesale brokers can handle all of the required surplus lines filings with the states. Full-service wholesalers will assist the retail broker throughout the policy term, providing market intelligence, claims assistance, day-to-day account maintenance and proactive renewal strategies in addition to traditional brokerage services. A professional wholesale broker presents a stewardship report to the retailer or assists the retailer in preparing this presentation to the insured outlining what services were performed over the past year and how they have benefited the insured. This presentation is also an opportunity to review the insured's business for strategic planning purposes, including renewal preparations and strategies.

The Economics of Wholesale Compensation

Let's quickly dispel a myth: Using a wholesale broker does not increase the cost of the insurance transaction to the insured.

Put simply, in our competitive business environment, each entity involved in a transaction needs to prove its worthiness in the equation by adding value without any unjustifiable increase in cost to the insured. Wholesale brokers that create client-relevant excellence through competitive pricing, coverage optimization and service enhancements become a valuable component of the placement team.

Wholesaler Selection

For a retail broker, choosing a wholesale broker is an important decision. Beyond delivering capacity, wholesale brokers that employ best policies and practices earn a role on the placement team through their use of structured data analysis and market intelligence. This is a critical benefit, especially in today's climate where insureds are initiating Request for Proposals (RFPs) with more frequency. As part of the ripple effect from the transparency movement, insurance buyers are becoming more involved in the wholesale selection process. As such, retailers who want to effectively compete in the RFP process will routinely invite their entire team, including the wholesale broker, to participate in the RFP response (both written and oral) to the Insured. Retailers who pool their resources are more likely to offer a comprehensive and effective RFP response that earns the Insured's business. Ultimately, wholesalers are not adding to the cost; rather, they are adding value to the placement team.

The Flawed Logic of Added Cost

Retailers with broader resources than their competition have advised insurance buyers that a competitor who uses a wholesaler is adding cost to the placement. The argument goes like this: the more parties involved, the higher the associated costs to pay for each party's contribution. The flaws in this logic are obvious when the insurance buyer recognizes that the wholesaler and retailer, working as a team, can outperform standalone retailers in pricing and service standards. The additional market access offered by a wholesale broker assists the retail broker by providing greater pricing leverage against the retailer's direct markets and vice-versa. The result is premium savings for the insured.

Placement Team Compensation

Wholesale brokers are compensated by commissions paid by the insurance company. Depending on a retail broker's compensation arrangement with the insured (commission from an insurer or fee paid by the insured), an agreement between the placing wholesale broker and the producing retail broker (working as a team on behalf of their mutual client) determines how the commission or fee will be allocated between the parties. In many cases, the total commission paid by the insurer can be the same regardless of whether a wholesale broker is involved; some carriers, however, pay a slightly higher commission percentage when a wholesaler is engaged because the higher commission is more than offset by the carrier's lower distribution costs. By relying on wholesalers, carriers avoid the cost of operating a large retail network. In addition, by working with wholesale brokers who are experts in their field, underwriters can be more productive and efficient because of the quality of risk data in the submissions and the likelihood that the risk presented will be an appropriate match for their underwriting appetite.

Compensation Summary

The insured incurs no additional charge by using the services of a wholesale broker while accessing the substantial benefits of superior market knowledge and placement expertise. With a wholesale broker, the insured has the advantage of increased competition for its business through wider market access, thorough preparation of all pertinent documentation used in the placement process, and the most cost-effective coverage design. The wholesaler, by adding value and efficiency to the process, earns its place as an efficient member of a powerful placement team.

Conclusion

Insurance is an intensely competitive business, and risk managers who demand a strong insurance placement team will secure the best insurance coverage and the broadest terms for the most attractive price. By the same measure, retail brokers can increase their client's satisfaction by building a placement team that includes a wholesale placement specialist. Retail brokers who take a long term, strategic view on how to best meet the needs of insurance buyers will partner with the right wholesale broker. In doing so, they solidify client relationships, improve retention, attract new clients and ensure a clear path to their own continued success.

About NAPCO®

Established in 1996, NAPCO is a full-service property wholesale broker headquartered in Iselin, New Jersey, with offices in the U.S. and Bermuda. We work with retail brokers to meet the complex and difficult risk-transfer needs of commercial insureds and public and private entities through our global network of property markets. At NAPCO, we pride ourselves in providing the highest level of professional program design, marketing and post-placement services. NAPCO offers access to the global insurance market, including major and specialty domestic and international carriers, excess and surplus lines markets and reinsurers. As a result of our personal relationships, we enjoy direct access to senior underwriting decision makers and we understand their needs and expectations. This enables us to provide our clients with comprehensive, dependable and cost-effective solutions for their needs.



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