### THE BROKERS' ROLE IN

### ENGINEERING INSURANCE

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A PRESENTATION TO THE 27th CONFERENCE OF THE INTERNATIONAL MACHINERY INSURERS' ASSOCIATION SEPTEMBER 1994

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## THE BROKERS' ROLE IN ENGINEERING INSURANCE

#### 1. INTRODUCTION

This paper has been issued with a view to stimulating contributions to a discussion following a brief presentation on the brokers' role in Engineering Insurance at the 27th IMIA Conference. In this context Engineering Insurance includes all classes of traditional engineering insurance and all classes of construction insurance.

It is then hoped that the main substance on this topic will emerge from the delegates' participation in the discussion, for summary and inclusion in the Conference Minutes.

The paper sets out some thoughts on current changes in the brokers' role, how Engineering Insurance particularly is affected, and the scope for engineering insurers to influence the brokers' role for the benefit of engineering insurers and the wider insurance community generally.

#### 2. THE BROKERS' TRADITIONAL ROLE

Expressed in its simplest terms the role of the broker has been defined as the placement of insurance at the lowest premium for an adequate cover to meet the insurance requirements of his client, whilst making a profit for himself in the conduct of the business.

Certainly brokers often (some might say always!) act as if pursuit of the lowest premium is their only mission. Some clients concentrate brokers' determination to seek the lowest premium by offering the business to more than one broking firm, and then awarding the placement of the business to the broking firm which produces the lowest quotation from insurers.

More sophisticated clients, hopefully to be found in the Engineering Insurance market, recognise that a good broker does far more than simply place business at the lowest premium. The sole appointment of a single broking firm at the outset should be the reward of those which have firstly demonstrated their competence and professionalism in the classes of business to be conducted. This requires an investment by broking firms of time, effort and resources - an expensive strategy which will discourage those firms which realise they are unlikely to be given the business to place in the face of the competition for the segment of business on offer.

Perhaps the most traditional criterion on which clients select their brokers is the broking firms' reputations for their negotiating power based on the volumes of business they transact. To a greater or lesser extent, the personal contact and confidence shared by the broker's representative and the client's key insurance personnel is a further factor, although unquantifiable, which intermingles with the other more tangible reasons for a broker's appointment to conduct business on his client's behalf.

#### 3. BROKERS AND BUSINESS VOLUMES

There is a familiar maxim that it is better for an insured to be the third most important client to a medium-sized broker rather than the hundred and third most important client to a major broker. Some recently published information for 1992 illustrates the mutual affinity between the major brokers and the major corporations. One major broker acted for 165 commercial clients who together had an aggregate annual turnover of nearly US\$ 150 billion (US). Such clients had on average an annual turnover of about US\$ 900 million, a fairly typical figure for clients of the top five broking firms. These top five firms were the brokers for more than half of the corporations having annual turnovers exceeding US\$ 1.5 billion (US) each.

At the other end of the scale, for clients having annual turnovers below US\$ 30 million each, the same top five broking firms were the brokers for about a third of these smaller corporations.

Clearly, the major broking firms are powerful and important institutions, particularly in the conduct of insurance business for the major corporations among whom engineering insurers will find their principal markets.

Reverting to the typical large corporation with an annual turnover of US\$ 900 million, its annual expenditure on premiums for all classes of insurance may range up to about US\$ ten million, rewarding its brokers with a commission between US\$ 1 million and US\$ 2 million.

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#### 4. ENGINEERING INSURANCE BROKING

One leading engineering insurer has stated that, on average, only three per cent of a broker's time is spent on dealing with engineering insurance. On a proportional basis, the typical large corporation would pay premiums of about US\$ 0.3 million for its engineering insurance. Naturally, many individual representatives of the major broking firms are specialists in their own fields, concerned only with the traditional engineering and/or construction classes of business. Others are multi-discipline representatives of the broker, usually with a main interest in fire insurance and sometimes other classes of insurance also, especially among the smaller national or provincial brokers. In such cases, it often falls on the shoulders of the engineering insurer to inject the necessary expertise to determine the details of the cover to best meet the needs of the insured and in some countries to advise on the associated plant inspections required. However, it is not unknown for major broking houses to seek similar assistance from engineering insurers.

The multi-discipline pattern of some brokers' commercial representatives is even more pronounced among the brokers' technical personnel. The broking firms with the best resources employ technical specialists with expertise in the main industrial sectors where the broking firm has a large volume of business, in addition to a fine-mesh network of specialist fire surveyors serving each major city and beyond. Proceeding down a tabulation of broking firms from the largest to the smallest, there is a rapid decline in the numbers of fire surveyors employed in relation to the brokers' volumes of fire business. For their Engineering Insurance business, the decline in the numbers of engineering technical specialists are found to plummet by comparison.

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Even some of the major international broking firms have to scan their global resources to seek an engineering technical specialist with the specific expertise required. It seems that such searches are very often unfruitful, to judge from the brokers' frequent invitations to insurers, proposers and sometimes independent consultants to assist with the preparation of underwriting information prior to the business being offered to the Engineering Insurance market.

#### 5. CHANGES IN THE BROKERS' ROLE

There is little evidence to suggest that changes are occurring, or are likely to occur, in the broker's central function - the placement of insurance as defined at the beginning of Section 2.

The recent changes in brokers' activities therefore are to be found as additional services to their clients beyond the placement of insurance. Some examples follow in the next four sections of this paper. They are:

- Risk Management
- New Types of Cover
- Novel Extensions of Cover
- Supplementary Services.

#### 6. RISK MANAGEMENT

Reparability

Risk Management services have become a principal growth area of brokers' activities, with significant changes in the scope, timing and remuneration basis for the services provided to clients.

Risk Management has been formally defined as an analytical method by which exposures to risk are identified, the potential frequency and severity of incidents are assessed, leading to controls to reduce risk being put in place through appropriate precautions and procedures, with the consequences of any subsequent loss being met by the client or/and by insurance.

At one time, brokers' underwriting information for an engineering risk was little more than a schedule of the property proposed for fire insurance. Nowadays, engineering risk control surveys and assessments are no longer rare, although not yet common, for the larger industrial cases. Some of the major broking firms have taken their involvement still further by undertaking a full risk management service for their major clients and by presenting insurers with underwriting information which includes the substance of their risk management activities.

Hence, the sequence of brokers' activities for the larger engineering risks is gradually changing from:

|    | I   | (1)  | receive copy of fire insurance schedule      |
|----|-----|------|--|
| or | I   | (ii) | prepare inventory of plant and machinery     |
|    | II  | (i)  | receive client request on extent of cover    |
| or | II  | (ii) | discuss and define scope and extent of cover |
|    | III | de   | etermine adequacy of market capacity         |
|    | IV  | Vá   | alidation of security                        |
|    | V   | ne   | egotiation of premium price                  |
|    | VI  | pl   | lacement of insurance                        |

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VII (i) service the account

or VII (ii) service the account, including offering to the client the broker's risk management services if available, possibly following a large claim.

For the future, it is increasingly likely that the sequence of brokers' activities for the larger industrial cases will be:

- I secure appointment as the client's sole broker
- II conduct a full risk management service for the client's assets and earnings, defining the optimum scope and extent of insurance cover
- III determine adequacy of market capacity
- IV validation of security
- V negotiation of premium price
- VI placement of insurance
- VII service the account, including the continued application of the broker's risk management services.

Some broking firms estimate that more than 60% of their operating costs are incurred in initial client discussions and the risk assessment phase of their activities. The rest of the broking firms' operating costs are incurred on premium negotiation, placement, policy amendments (cover, terms, conditions), premium collection and claims handling.

As the limited risk assessment practice expands into a fully developed risk management approach, the balance of the brokers' operating costs will swing ever more heavily towards the costs incurred prior to placement of insurance. For this and other reasons, the trend is for the fully developed risk management service to be paid by the client on a fee basis - a professional fee for a professional service. The provision of an effective comprehensive risk management resource incurs operating costs which produce a disproportionate financial burden on the smaller and mediumsized broking firms. This may be one of the factors contributing to the recent crop of amalgamations among broking firms, evidenced by the national broking firms' acquisitions of regional brokers in the provinces and by the recent amalgamations on an international scale. This agglomeration of broking strength provides a more viable basis for the employment of technical experts in the classes of insurance with a relatively low business volume. The servicing of Engineering Insurance should improve accordingly.

As an example, one major broking firm has recruited four power station engineers to its UK staff, each with almost a lifetime's experience in power generation, to provide technical expertise in that sector of the business. From an Engineering Insurance viewpoint, the risk assessment studies produced by that firm are a huge improvement on the earlier efforts, with a corresponding advantage over its competitors.

Similar developments had already taken place in the petrochemical sector, long considered to warrant the provision of technical specialists within the major broking firms handling this business. The philosophy is now seen to be spreading to other sectors of Engineering Insurance.

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#### 7. NEW TYPES OF COVER

The ever increasing international nature of the major broking firms has promoted the spread of some classes of insurance from their indigenous countries of origin across frontiers to create new markets. One recent example is the classic decennale insurance, devised and developed in France, which now appears in various forms in many countries. The paper presented by the Swedish delegation at the 25th IMIA Conference two years ago provided a thorough and detailed description of these developments.

At the instigation of brokers, some engineering insurers now offer a supplementary medium-term cover for the building services plant and machinery.

#### 8. NOVEL EXTENSIONS OF COVER

Engineering insurers, like other insurers, face requests from brokers to extend cover beyond the customary market practice current at the time.

For example, not long ago the market norm for maintenance cover on erection policies was limited to one year. Increasingly, two years of maintenance cover is now being granted, although the more fanciful requests for up to five years maintenance cover do not find acceptance from engineering insurers generally.

Resistance has also been aroused among some engineering insurers against the imposition of a non-invalidation clause in erection and machinery breakdown policies which brokers have sought to include at the behest of the funding bankers. Whilst such clauses are not uncommon for construction policies, the different nature of the risks on engineering erection projects and subsequent operation renders the insurer much more vulnerable to a large loss under a non-invalidation clause. From a small pocket of resistance two years ago, the major UK engineering insurers now have in sight the common goal of rejecting non-invalidation clauses in engineering erection and machinery breakdown policies, despite considerable and concerted broker pressure.

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The principal items in modern power plants are large and expensive gas turbines, often of an unproven prototype status. In such cases the risks arising from the developmental nature of the gas turbines are inappropriate for the conventional cover of engineering policies. Brokers have joined forces with manufacturers and project sponsors to press their opposition to the stance taken by the major engineering insurers and re-insurers. For the moment, the broking firms have come to accept the situation with reluctance and dismay. Some broking firms' most recent stratagem on this issue has been a far gentler approach, seeking to inform and reassure, and appealing for support.

#### 9. SUPPLEMENTARY SERVICES

The advancement of information technology systems has given broking firms the opportunity to improve their traditional services of premium collection and claims handling. Some have extended their services by offering their clients computer systems to record all aspects of plant and machinery including inspections, tests, maintenance and repairs, also the written scheme of examination for pressure systems together with relevant preparation and examination schedules. Records can be kept on inspection authorities, and on accredited examiners and their qualifications.

Some major broking firms are taking an initiative in using their technical specialists to develop concepts fundamental to the conduct of Engineering Insurance. For example, in conjunction with industrial research organisations, a broking firm has developed a new method for the estimation of probable maximum loss in the petro-chemical sector.

Often as part of their risk management services, broking firms offer to advise their clients on the establishment and operation of captive insurance companies, sometimes seconding members of the brokers' staff for this purpose or assisting their clients with the recruitment of staff for the new captive insurance companies. This service may be extended to assistance with the recruitment and selection of personnel needed by the client's insurance department for the conduct of the department's normal activities.

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#### 10. BROKERS AND ENGINEERING INSURERS

When engineering insurers maintain their underwriting discipline in the face of broker pressure, they are able to control the situation, establishing a prudent position which is eventually accepted by the broker, albeit with reluctance. Some examples have been given in Section 8 of this paper.

However, it would be a distortion to over-emphasize the points of difference between the views and actions of brokers and engineering insurers. They all share several common objectives, and the recent changes in the brokers' role should produce net benefits to all involved, including engineering insurers.

A higher quality of risk information presented by a broker will better enable engineering underwriters to determine the most appropriate terms and conditions when a proposal is submitted. The involvement of the technical specialists among the staff of the broking firm should contribute to more efficient claims handling.

These improvements will be most welcomed by insurers lacking their own technical specialists to participate in the conduct of Engineering Insurance. Although having their own extensive resources of technical specialists, testing equipment and laboratories, the Engineering Insurance companies may also welcome the incoming new style of participation by the major broking firms, using the insurers' own engineers to carry out more detailed examinations into aspects of particular interest to the insurers.

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From a broker's viewpoint, their risk management activities will strengthen contact and relationships with their clients, provide a public relations opportunity to raise the profile of the broking firm and make available a useful source of local market intelligence. In those countries where engineering insurance companies have engineer surveyors carrying out periodic plant inspections, they are better placed to maintain recognition of their services to the insured, despite the rising profile of the broker in the eyes of his client.

Like the major broking firms, the major insurers have their own risk management resource, either in the form of a separate division or a separate subsidiary company. Clearly these brokers and insurers are in competition for risk management business, and insurers may wish to consider expanding their risk management resources by including technical specialists to cover the engineering sector. This should enable insurers to enjoy similar benefits from their risk management activity, as already recognised by brokers and described in the preceding paragraph.

Virtually all insurers issue publications which are distributed to the broking firms for marketing purposes. Some publications cover the range of insurance classes offered by a composite insurer, with references to Engineering Insurance often comparatively subdued, sometimes doing little more than to remind the broker that the company underwrites Engineering Insurance. The engineering insurance companies produce appropriately focussed publications in which there is ample space to include technical articles aimed at informing the recipients, and with any marketing mission subtly muted.

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Other insurers have begun to follow a similar philosophy, distributing publications specifically produced to help brokers become more aware, knowledgeable, confident and competent in an eclectic sector of business. Among the categories of Engineering Insurance, examples of recent publications have included commercial building construction and engineering manufacturing. The publications are devised solely to inform brokers and are devoid of marketing matter.

To conclude, brokers and engineering insurers are all part of an insurance industry which will better prosper when there is trust, confidence and harmony among the participants. Engineering insurers can help to promote a healthy market ethos by the cultivation of good business relationships with brokers, and by supporting those brokers who conduct their business in a truly professional manner. Brokers are the customers in their relationship with engineering insurers, who should ensure that brokers receive the service they deserve.