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How Much I$ Your Broker Worth? by Michael A. Papa, CIC, MBA

Many commercial insurance buyers grimace at the thought of carving out a part of their bottom line to pay for another year's Property & Casualty (P&C) Insurance Premiums. Some see it as a necessary and valuable transfer of risk, allowing them to operate with less fear of a catastrophic loss that might otherwise put the firm out of business. Many others see the payment as a drain—required by forces outside their control: the state(s) for workers' compensation, the Motor Vehicle Administration (MVA) for auto fleets, the banks and lessors for property, and customers for liability. Whatever the perspective, the topic garners attention due to the significance of the cost.

Insurance programs are often analyzed for adequacy of coverage and limits, as well as the "price per pound"—that is, the total cost relative to the size of the risk, whether the defining parameter is payroll, sales, auto units or property value. One item rarely examined is the portion of premium cost—often significant—allocated to the broker. Traditional broker compensation is in the form of commission—often a straight, albeit hidden—percentage of the insurance premium. Is the broker compensation "fair"? The answer depends on the amount of compensation relative to the value of the service provided. If the income is in the form of commission, only one thing can be said for certain: if the compensation is fair, in my opinion it is purely by accident.

Some background: Commissions usually fall between three and seven percent for workers' compensation (WC) policies, and between 10 and 20 % for other lines of insurance. Depending of the level of WC to the entire commercial P&C account, the total commission is usually in the 11-13 percent range. Hence, for an account paying $500,000 in commercial P&C premium, the insurance agency might receive $60,000; the salesperson's portion of that $60,000 depends on the arrangement he/she has with the brokerage firm. For what is the insurance buyer receiving for that $60,000? It depends on the broker. At a bare minimum, the broker is a necessary conduit through whom a policy is purchased. That is, the buyer cannot obtain coverage directly from a carrier in most cases. Depending on the broker, the following other services may also be part of those offered by the broker:

1. Marketing the account regularly to assure the best combination of coverage, cost and carrier. The quality of the marketing process depends on many factors, including:
    a. the broker's access to markets.
    b. the broker's volume and profitability with those carriers.
    c. the broker's skill in technical areas as well as in "selling" the account to prospective carriers.
    d. the amount of time and effort the broker allocates to the account.

2. Regular reviews of coverage to assure the buyer is aware of exposures to loss

and where the buyer stands on risk transfer relative to them (i.e., are the risks being transferred via insurance, avoided or assumed [self insurance]?).

3. Assistance with issues related to claims and loss control, including regular reviews to assess trends and reviews of open claims to affect:
   a. lower frequency, and
   b. a reduction of open reserves, which translates into lower premiums.

4. Advice on risk management issues throughout the year—similar to that provided by other disciplines such as accounting and law.

5. Review of contracts with special attention to insurance related issues.

6. Responding to service requests in an efficient manner, such as changes in coverage and certificate requests.

So why would a fair commission be an accident? Imagine the following scenario: An account pays $250,000 annually in WC insurance. The commission is five percent, or $12,500. The broker is purely a conduit for purchase. Assuming there is no assistance on the six areas mentioned above, losses spin out of control, the Experience Mod goes through the roof, and the WC premium skyrockets to $500,000 annually. The broker's penalty for ineptitude? A 100 percent raise.

Many buyers attempt to keep their brokers "honest" by shopping the insurance through several brokers. However, with the changing landscape of the P&C market, characterized by fewer carriers with more volume specializing in writing only certain types of businesses, buyers often have their account declined by underwriters who do not sense a true opportunity for success. Might it be better to perform due diligence on picking a broker (as a buyer would for legal counsel or a CPA), assure accountability, and allow that broker to control the market on behalf of the buyer? Many buyers are moving in this direction. One means to assure accountability in my opinion, is to separate the broker compensation in the form of a fee. An interesting note: some states require that, if a fee is charged, a commission cannot also be charged—but many states are silent in this area. Hence, any fee agreement should include language to assure that the fee is comprehensive with respect to broker compensation, to avoid a "double dip" on the part of the broker.

A fee structure provides some of the following advantages:

1. It ensures accountability. Brokers feel compelled to justify, in the form of specific services, the fee they are receiving. The fee is related to the quality and quantity of service. The correlation is inexact, but there now is a correlation where before, with a commission structure, there was none. In fact, in absence of service accountability, the broker incentive is to spend time selling another account, ignoring the buyer's interest.

2. It removes any ulterior motive for suggesting increases in coverage; it takes that issue "off the table."

3. It removes a tie-in between broker compensation and a cyclical insurance market; a separately negotiated fee does not increase in response to a hardening market characterized by rising insurance premiums.

4. It allows the fee to be separately negotiated, allowing the buyer more control in the purchase.

An effective insurance broker can be, should be and sometimes is an important advisor to a commercial entity. Perhaps it's time to view that relationship in the same way one views other advisor relationships—as mentioned, like those of the CPA and legal counsel. One aspect of that transition includes compensating for services in a similar manner, for the reasons presented in this article. Traditional broker compensation, on closer review, seems arbitrary. To gauge the relationship with a buyer's current broker and to help determine if a buyer is receiving adequate value for the dollar, a buyer might ask the current broker two things:

1. How much are you receiving (commission, income, contingency income—everything) on my account, and

2. What services are we receiving for that compensation?

If uncomfortable with the response, one might consider exploring another relationship.

Editor's Note: Michael Papa's article dovetails with developments we are seeing in the insurance industry. As SBC readers may know, a few months ago New York's Attorney General Elliot Spitzer launched an assault against Marsh, one of the largest national insurance brokerage companies. Mr. Spitzer sued Marsh for bid rigging among other things. However, the underlying theme of Spitzer's suit, a topic that is catching some attention, relates to what are referred to in the insurance industry as "contingent commissions." Contingent commissions are an additional type of commission paid to agents and brokers who place a large volume of business with an insurer. The criticism that is being levied relates to whether an agent or broker who receives a contingent commission is truly objective when recommending certain insurance policies to his or her clients. In other words, to what extent is the potential commission the reason for making a particular recommendation? In fact, the topic of brokers being paid commissions by the insurance carriers and not fees from the insureds has been flushed out by Spitzer's action.

Most of us would like to believe that insurance professionals are for the most part honest and ethical. The vast majority try to do the right thing for their customers regardless of their compensation agreements. With that said, if insurance agents/brokers want to be considered as professional advisers to their clients, rather than sellers of a commodity, Mr. Papa and others would suggest they may want to consider moving to fee-based services and away from commissions. This ultimately leads to full disclosure and eliminates any doubt as to where the agent broker's allegiance may lie.

Mike Papa is a Vice President at Diversified Insurance Industries with 23 years of experience in the insurance industry, having worked in various capacities on both the carrier and brokerage sides of the business.

SBC HOME PAGE