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Article abstract

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The Future of Insurance Intermediaries*

by

T.H. Irvin**

À travers les propos de l'auteur, nous découvrons l'évolution de la notion de courtier d'assurance. Aujourd'hui, le courtier doit s'adapter à un environnement plus complexe et à des rôles nouveaux.

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Introduction

One's view of the future of the insurance intermediary is necessarily driven by one's definition of the brokerage business. Using historical definitions, the broker's future might appear tenuous. But those who cling to historical definitions of the business are analogous to those who once defined "surface transportation" as "horses and buggies."

Certainly horses and buggies were the primary modes of travel at one point in our history. And certainly transaction-focused, sales-oriented brokers who were paid solely on

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The author's bibliography has been omitted.

** Mr. Tinsley H. Irvin is Chairman and Chief Executive Officer for Alexander & Alexander Services, Inc.

commission for transactions were, at one point, the future of our business.

This paper provides a different view of the intermediaries' future. Those who cling to the traditional definition of a broker will be woefully unprepared for the future. For those who anticipate and adapt to changes in all aspects of the business, the future is bright.

In the discussion that follows, our emphasis will be property/casualty oriented, and we will deal primarily with the more industrialized countries.

The first section of this paper will discuss pressures on the intermediary as historically defined, as well as continuing pressures on the brokerage business as it is conducted today. The next section will focus on the changing nature of client demands that will drive changes among intermediaries. This discussion will lead to a portrait of likely changes in the sources of future revenues for brokers.

Against this backdrop describing a climate of significant change in many of the intermediary functions, we will examine the globalization and consolidation of brokers. These explorations are followed by a discussion of the emerging role of technology and a description of the changing human resource patterns in the intermediary business.

Finally, this paper discusses the litigation and liability crisis in the U.S. that shows signs of being exported overseas. While the lawsuit explosion generates certain insurance opportunities, it creates a heavy burden for individuals as well as for organizations of all sizes.

Definitions

In 1923, a prominent insurance intermediary, George LaBoyteaux, defined a broker as one "who represents persons desiring insurance, effects it for them and looks after their insurance needs, advising them as to losses, interpretations of the

terms of policies, etc."[1] LaBoyteaux outlined the qualifications needed for a broker as "a high degree of business integrity; no small measure of diplomacy; a thorough knowledge of the underlying principles of insurance; familiarity with the customs and practices of trade; the power of analysis; and an unusual amount of personal application."

Early definitions such as these focus on a broker who helps bring about a transaction and gets compensated for doing this. That sort of perception is very different from the view emerging today of a broker as an advisor to management, in a consultative role, helping to avoid financial surprises through state-of-the-art risk management practices. Today, at least one official definition of an insurance intermediary moves in that direction. The definition has been expanded to those who "have knowledge of highly specialized insurance markets, provide risk management and loss control services...."[2]

Note the change in focus from a broker who effects a purchase of insurance to someone with knowledge of markets who provides complex, specialized services. How did this change come about—how did the broker's function evolve from simple insurance buying to provision of valued advisory services?

The answer is that the world changed. The entire business and social environment became infinitely more complex. Economic specialization, division of labor and technological advances in agriculture, commerce and industry combined with advances in science that enabled people to live longer and engage in more varied and complex activities. While all this was taking place, social changes were occurring rapidly and government became increasingly involved in regulating businesses. At the same time, insurance capacity, coverages and pricing became unpredictable.

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[1]George B. LaBoyteaux, address to the Insurance Institute of America (December 13, 1923), p.1.

[2]George E. Rejda, *Principles of Risk Management and Insurance*, 4th edition, HarperCollins Publishers, Inc.: New York, NY (1992), p. 586.

The intermediaries who have prospered in the 20th century have recognized these factors and have adapted with speed and flexibility. Their sense of how to add value to serve emerging client needs caused them to redefine their mission from the simpler concept of buying insurance to a more systematic risk management approach.

Pressures on the business

One sign of maturity in any industry is that levels of economic activity fail to generate real dollar volume growth. In North America, insurance is showing signs of becoming a classic model of mature industry.

The U.S. property/casualty markets have been growing at low, single-digit rates. In fact, in recent years, real growth in the U.S. has been almost nil. Thus, the U.S. can be seen as a mature market for brokers; although there is more room for growth on a global front.

During the last decade, growth in non-life premiums in many key parts of the world also has been slowing significantly. Exceptions will continue to exist. For example, premium growth has been more significant recently in Korea, Brazil, Thailand, Chile and Mexico.

On balance, however, those brokers who view their business as an attempt to sell insurance regionally and receive commission income face a discouraging outlook for growth rates. One of the largest U.S.-based insurers, for example, projects no increase in the North America market during the 1990s.

That finding is significant when one considers that for the non-life sector, the United States accounts for nearly 46 percent of the world market. Japan is second at 11 percent. However, in the late 1980s, when U.S. growth rates slowed, Japan's insurance growth rate also experienced a substantial decline. This generally is blamed on the restructuring of Japanese financial markets, the weakening of the yen against the dollar and the decrease of

"maturity refund" policies sold on general property insurance and accident insurance.

At least one global insurer suggests the need to look not around the corner for continued growth, but instead, around the world. The projections indicate stronger growth in the 1990s in Asia (31 percent), Western Europe (29 percent) and Eastern Europe (29 percent).[3]

Another way to look at the relative maturity of the U.S. market is to compare insurance premiums to the Gross Domestic Product (GDP), providing insight into the depth of the industry's market penetration. Comparing premium income to GDP, the U.S. leads all countries with premiums representing 5.13 percent of GDP. Japan, with the second-largest share of the world market, ranks 20th when measured by the percentage of its premium-to-GDP; while Germany, with the third-largest share, ranks 6th.

The disparities in the GDP ratios for the three largest insurance markets have three major implications. First, the percentage of premium income compared to GDP in the U.S. market is the most mature in the non-life insurance sector. Second, the U.S. insurance industry already has gone through its major growth period. In the future, it is likely to grow at a below average rate compared to other U.S. industries and to the insurance industry in other countries. And third, GDP ratios of Japan, Germany and other countries indicate that there is much potential for growth before their insurance industries reach the same level of maturity as that of the U.S.

The U.S. intermediary industry has developed along parallel lines with the insurance industry as a whole. There is no question that if the brokerage industry in the U.S. is to grow, it will have to look beyond its traditional North American client base.

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[3]Bengt Westergren, AIG, paper presented to European Insurance Forum: London (February 18-19, 1991). Reprinted in "Insurance," *Industry & Trade Summary*, Publication 2456 (SV-1), United States International Trade Commission: Washington, DC (1991), p. 21.

Price Competition

The brokerage business has been intensely competitive throughout the last several decades. Today, the business is increasingly competitive, as can be expected given the signs of economic maturity referred to above. One broker recently noted informally that intermediaries are "not only fighting for clients, but are feeding off each other in a shark tank because the pie isn't growing."

In the small to mid-size insured market, there is competition between brokers and insurance agents. In the large insured markets, there is some competition between brokers and underwriters. In addition, there is now competition between brokers and consultants.

The degree to which the price of insurance affects the insured's decision about the shape of risk management programs depends upon a wide variety of factors, including the size and sophistication of the insured. Though commissions are paid by insurers, they obviously are funded by clients. Consequently, clients are increasingly focusing on commission rates, as are underwriters who are sensitive to distribution costs as a percentage of their overall expense base.

Investment Income Impact

The amount and cost of capital available to underwriters directly affects the price of insurance. In the non-life sector especially, the industry has been cyclical in nature. This is, in part, because of the fluctuation in investment yields. When financial market yields are high, new companies enter the marketplace and compete to accumulate capital for investment. At that point, the consumer has more insurance options, and premiums fall.

The basic nature of this investment cyclicality has been outlined in a variety of prior publications. During a period of high rates of return, underwriting losses incurred by insurance companies are compensated for by investment income. This

phenomenon is called cash-flow underwriting. When profits fall, companies exit the market (or portions of the market), and capacity shrinks. Remaining insurers increase prices to restore profits and capital.[4]

In 1991, the economy of the United States both helped and hindered the property/casualty industry. Although interest rates were low, the equity and bond markets bolstered the worth of insurers' portfolios. Capacity remained abundant so that the soft market continued. Price declines on Wall Street that lessen portfolio values could cause a market turn. However, there is no dependable basis for predicting the end of the current soft market.

Cost Pressures On Underwriters

Given the global economic slow-down, all businesses are experiencing pressure to cut costs. Among underwriters, brokers are generally regarded as an expensive form of distributing insurance products. Hence, there are great pressures to reduce broker expense.

As underwriters consider possible approaches to cutting costs, two factors influence their attitudes toward brokers. First, there is a degree of resentment because of the view that some brokers "control" access to larger accounts. Second, underwriters express a complaint that brokers do not show more "brand loyalty," failing to recognize that "brand loyalty" is driven primarily by clients rather than by brokers.

While these attitudinal factors have a number of important implications, it is premature to predict any significant trend toward underwriters in the U.S. trying to take on the intermediary function. In the current U.S. environment, where managers generally are rewarded for eliminating layers of executives, carriers are reluctant to make the investments necessary to completely revamp distribution systems. To the

[4]Ibid., pp. 5-6. Also see David J. Cummins, Scott E. Harrington and Robert W. Klein, "Cycles and Crisis," Best's Review, Property & Casualty Edition (January 1992), pp. 15-20, 84.

extent that it does occur, the trend will be visible in the smaller end of the market rather than the "big ticket" arena.

One implication of underwriters' frustration with the distribution system is a trend to seek ways to communicate product information directly to the insured clients. This inclination to "reach over the heads of the brokers" will become more common in the years ahead. This should not be confused, with developing a corporate infrastructure that would allow markets to fully serve clients directly.

The discussion about "taking the function in-house" is mirrored by some corporate clients who seek efficiency and cost reduction by attempting to eliminate their reliance on brokers. However, in the U.S. this trend may be overstated. It is difficult to envision many organizations dedicating corporate staff to the specialized task of dealing with the markets around the world and with product and pricing, as well as knowing when it makes sense to buy and when to self-insure. Today's insurance industry is so fragmented that few corporations can survey the markets efficiently. In addition, the trend in corporate America to "downsize" and eliminate staff positions suggests the continued decision to "buy rather than make" with respect to insurance intermediary functions.

Pressures On Broker Income

In addition to all of the factors discussed above, there is an additional analysis that is useful in understanding the persistent soft market which produces lowered commission income for brokers, particularly in the U.S. Many insurers are not adequately recognizing losses in current prices and, therefore, are not pricing sufficiently. Although this is a very difficult hypothesis to test empirically, one can look at insurers' reported losses on income statements. Losses incurred include three types of losses: (1) losses paid, (2) known but not yet paid losses and (3) an estimate of losses that are yet to be reported, known as incurred but not reported losses (IBNR).

Insurers deduct losses paid from income when calculating net income. Because losses incurred include an estimate of both the amount of reported losses and IBNR to be paid, insurers may miscalculate their reported income. When the price of insurance is relatively "soft" (the current situation), managers can continue to lower prices by understating the losses incurred on their income statements. The error can be recovered over time, assuming that insurance prices increase and the market "hardens."

One can look at the growth rates in premiums collected and losses paid in the United States for some evidence of under- or over-reporting of losses incurred. For example, the premiums collected and losses paid from 1986 to 1990 were:

	Premiums collected	Losses paid[5]
1986	$172.3 b	106.0
1987	190.2	115.0
1988	107.9	132.8
1989	206.7	144.7
1990	216.4	157.3

One could assume that growth rates in these two areas should be approximately the same—that is, premiums should grow based on losses incurred. However, because an insurer can receive premiums on losses to be paid in the future, premium growth does not have to match the growth in losses incurred. In a stable environment, an equilibrium relationship would be established, and the growth rates would be similar. Because many factors influencing losses are changing, of course, one cannot stipulate what the exact relationship should be. However, looking at the growth rates, one can see that losses paid have been growing faster than premiums collected.

[5] *Best's Aggregates and Averages*, Property & Casualty Edition, A.M. Best Company: Oldwick, NJ (1991), pp. 134-137.

While firm conclusions are not possible, the data support the notion that losses incurred may not be reflecting the commensurate growth in claims. Consequently, either the price of insurance is not sufficiently high, or it was too high before.

This trend could indicate that companies are not going to raise prices in response to market forces that might otherwise lead to price increases. This would mean that the commission base for brokers is not going to grow as one might have expected.

Other structural factors play a role in pressuring broker income. Historically, insurance companies were set up on an inefficient organizational basis. Thus, brokers who were organized to deal with those companies were also generally inefficient in their structure. Additionally, brokers are coming to realize that they have done a poor job of understanding profitability on a client-by-client basis. Some have sought business on which they lost money without even knowing it.

The result of all these factors is that brokers now have to spend more money to overcome inefficiencies to accomplish the work necessary to earn the same commission dollars. This has eroded profit margins significantly.

Finally, insurance carriers will continue to require more expeditious premium payments, which reduces broker opportunities for profits on interim use of the money. The result of these combined pressures is a rise in brokers' costs and squeezing of margins.

Combining Intermediary Functions In One Company

Client service requirements have led larger, integrated brokers to establish or acquire operations serving each segment of the market. The impact of wholesale and retail broker affiliation on commissions depends on the market. But one can predict that as more retail brokers become affiliated with wholesale brokers, it will become more likely that competition will result in more efficiency and better quality service.

Serving Changing Client Needs

Alexander & Alexander was started in 1899 by two cousins in Clarksburg, West Virginia. The company began to grow in 1902 by serving the nearby growth industries of the day—coal, oil and railroads. Company lore has it that when one of the cousins wanted to obtain the B&O Railroad account in 1914, he learned that B&O would work only with local offices. The result was that he rented office space across the street from B&O in Baltimore, Maryland and won the account.

This story points to a determination to respond to the client's needs. In the previous century, that determination rested on one's ability to be "right around the corner." In the next century, that determination is likely to involve one's ability to be "right around the world." Accordingly, A&A and other leading intermediary firms have established offices all over the world.

The business, of course, is much more complicated today than it was in 1899. One key reason is the change in the risk management function. Historically, those whose sole responsibility was to arrange the insurance for a corporation frequently were titled "insurance managers" and were called "insurance buyers" by the trade.

The current description of this job, "risk manager," reflects the fact that this function is no longer simply "buying insurance." The risk manager of tomorrow increasingly will reflect familiarity with advanced formulas for identification, measurement, control and financing of risks—the building blocks of the profession. Risk managers of the future will have advanced degrees in management, accounting or finance; and they will use a new approach to risk management planning that is more systematic and strategic.

For intermediaries, the implications are enormous. Corporate clients are reevaluating the quality of services they receive at all levels, while simultaneously redefining the services they want.

For many risk managers, the emphasis in the future will be less on buying coverage and more on financial management techniques allowing companies to avoid cash flow and earnings/share surprises. This approach often involves unbundling traditional insurance products and services, reducing coverage by using higher deductibles and developing a variety of internal "insurance" capabilities. Certainly larger clients will look toward more complicated, innovative forms of risk treatment such as captive management and pooling arrangements.

Brokers who define their function by historical standards, as discussed at the outset, will simply be by-passed in many client sectors. The future of the insurance intermediary, in one sense, will simply "belong" to those intermediaries who understand the need to adapt to changing client demands. One useful way to understand the emerging broker role is to recognize the need to become part of each client's overall cost-containment effort.

For example, in the U.S. corporations are experiencing a crisis in workers compensation claims. In this climate, clients expect brokers not just to supply the lowest possible rates, but also to provide programs to make the workplace safer and reduce injuries. Services of claims auditing, loss forecasting, risk assessment, claims consulting and loss control engineering must supplement, and indeed in the long run are frequently more valuable than, an insurance proposal or price quotation.

The workers compensation area is just one example of how the actual purchase of insurance becomes a by-product of a "value added" approach by a sophisticated intermediary. Clearly, the broker's role of the future rests less on the ability to effect transactions for a commission and more on the ability to provide financial counsel to clients.

With these changes in the risk management function come changed reporting relationships around the world. A 1990-91 survey by the Manchester Business School found that in the United Kingdom the degree to which individual risk managers

have autonomy to select a broker is limited. The larger company is likely to have a separate risk/insurance department and a board of directors that takes direct interest in broker selection. Boards are more involved in considering recommendations which both will apply on a worldwide basis and will involve alternative risk financing.[6]

Perhaps more importantly, the changes in the risk management function mean that insurance buyers will have more "tools," i.e., more options, than ever before. Accordingly, if pricing cycles were to change abruptly as they have in the past, many clients would not necessarily have to pay the price. Instead, they would have an ever-broadening array of risk management options beyond traditional insurance markets. This should help moderate pricing "spikes" and will delay hardening of the markets to varying degrees around the world.

In addition, the emerging relationships with clients mean that large intermediary firms may revise the way they are organized. Specifically, the larger firms are likely to center their operations on clients and sectors of the economy where they have valuable expertise, rather than on geographic areas.

All of these changes and trends point in the direction of an intermediary function that is "relationship-driven" rather than "transaction-oriented."

How Intermediaries will be Compensated

In most service industries, income streams have become less tied to transactions and more to relationships. This has long been the case in accounting, for example. "Relationship pricing" generally implies fee income rather than "transaction" income, and this will be the wave of the future for insurance intermediaries.

Predictions in regard to commission income vary, and the percentage of a broker's income that is derived from

[6]"Summary of Findings Buyer Attitude Survey 1990/91," Financial Services, University of Manchester: West Manchester, U.K., p. 6.

commissions will depend upon the type of client served. But one can safely predict a decline in commission income and an increase in fee income for large intermediaries, particularly those serving a sophisticated, global clientele.

The adjustment in how intermediaries operate may be significant. Over the long term, however, the trend toward fee income has some advantages. Among them, fee income tends to "smooth out" revenue streams, making intermediaries less dependent upon market cycles. In addition, as relationships are built for the longer term, they may become more solid. Furthermore, although broking profit margins historically have been admirable, so too have margins in well-run consulting businesses, which increasingly will become the model for intermediaries.

Brokers who are hoping for the next U.S. market cycle, accompanied by an increase in insurance pricing, may have a very long way. As indicated above, the duration of the current soft market suggests a changing structure for insurance pricing. There is no shortage of global insurance capacity, and none is forecast. Since 1970, for example, property/casualty commissions have been based upon only 4.5 years of increasing prices and over 15 years of relatively soft prices.

In addition, as indicated previously, underwriters and clients can be expected to negotiate commission rates and fees if they are subjected to price spikes. Furthermore, as the business has become more global, with easier access to markets around the world, the cycle tends to become moderated, since global markets are unlikely to harden simultaneously.

Globalization and Consolidation

The future of insurance intermediary, for large participants in the business, will involve dramatic increases in globalization and consolidation. They will go hand-in-hand.

In the next ten to fifteen years—by the middle of the next decade—the intermediary business will be dominated by perhaps

five to seven large companies. Each will have significant "global reach" and expertise. Of the top 20 brokerage firms operating today, fewer than half will remain in their current form of organization.

Such predictions should not be misunderstood. The prediction of a handful of global giants does not mean that the rest of the firms, their people or their client relationships somehow will disappear.

Instead, intermediaries will witness combinations through mergers, acquisitions and other forms of affiliation. This will allow service providers to enjoy economies of scale and to find resources necessary to serve the clients of the future.

Large U.S. insurance brokerage houses already have established a major presence in the European Community. This is especially notable in the United Kingdom, where several major U.S. brokers have gained direct access to the Lloyd's market. The reverse is true as well, because large U.K. brokers also have established presences in the U.S.

The global brokers' knowledge of the international underwriting markets is essential for serving larger clients. In addition, although smaller and mid-sized clients often do not perceive the benefit of dealing with a global broker since they do not think about their insurance needs in cross-border terms, they too can benefit from the access to world markets that is available through brokers with global reach.

The majority of the larger global brokers may be based and organized in the U.S. In contrast, the trend is toward expansion of European-based insurance giants such as Allianz, Generali and UAP. So the underwriters of tomorrow may be based across the oceans from the intermediaries.

Similarly, European companies continue to dominate both international and U.S. reinsurance markets. U.S. providers of reinsurance have been content to concentrate in the domestic market. The largest U.S. reinsurer, General Re, obtained only about 5 percent of its premiums abroad in the late '80s, for

example. This compares with 90 percent for the Swiss Reinsurance Company or about 70 percent for the largest British reinsurer, Mercantile & General. However, most of the major U.S. reinsurance companies have a presence in London, Zurich or Brussels, reflecting the inherent international aspect of the reinsurance business.[7]

In the emerging global insurance environment, small- and middle-market and "niche" brokers will not necessarily encounter financial difficulty. Some will prosper, particularly if they select the proper market niches and abandon the goal of "becoming all things to all people."

The large intermediaries can be expected to continue competing for relationships with the multinational corporate clients. This reflects the investments most of them have made in building their global networks. Only large brokers will have the capital, personal and resources necessary to specialize in numerous industries internationally. Their multinational clients more than ever will need professional and independent advice to explore, design and implement alternatives to the dominant insurers' offerings.

Relevant literature is full of descriptions of the large, global brokers. Independent intermediaries are described as having the ability to offer a range of impartial services, including professional counsel, risk strategy alternatives, access to world insurance markets, risk management systems and detailed knowledge of managing risk and insurance programs.[8]

Those brokers that are considered truly global will need broad product lines and full-service capabilities; expertise in selected products and services; economies of scale that lower costs by centralizing key operations; market power and clout with underwriters; innovative financing alternatives; unique positioning to service multinationals, including access to Lloyd's

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[7] Westergren, pp. 24-25.

[8] Stacy Shapiro, "Panelists Divine Different Futures for Marketplace, " *Business Insurance* (October 28, 1991), p. 3.

underwriters; large international service capabilities; longevity and staying power in markets; local staff; and expertise and innovative services.[9]

Beyond the attributes listed in the literature, however, the global intermediary will need to be able to provide a "seamless" level of service with "invisible" geographic barriers. The international broker must be ready to deliver service to clients wherever it is needed, so that location in no way determines quality or value of the service. A risk manager for a huge, global company wants to be able to rely on the same excellent service, whether dealing with an individual broker in Omaha or Paris. Success or failure in delivering this seamless service will make or break a company.

At the same time, intermediaries will find it necessary to accommodate cultural difference. Although the world economy is harmonizing, the legal and economic environment in individual countries will remain different to a great extent, even after the European Community merges into an integrated single market.

The Pacific Rim

In Asia, for example, the broker will find it extremely important to learn the customs of the various countries. Differences of language, tradition and mentality will persist, all of which play an essential role for the insurance business.

The pace of the growth opportunities for intermediaries will vary around the world. In Asian markets, once tightly regulated, one now finds an attractive opportunity for the brokerage industry. While there is disagreement among experts as to the extent that the consulting arrangements will be utilized in these regions, intermediaries should be able to earn substantial income for their work.

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[9] Allen Mottur, "Little Room for Euphoria," *Best's Review* (March 1987), p. 20.

Singapore presents an open market for intermediaries, having no restrictions on ownership or access to local business. Intermediaries have approximately a 20 percent share of the market but a big share of the top-end business. Intermediaries are normally tied in with large conglomerates or banking groups. Here, too, reinsurance brokers are very active and are totally free to import or export premiums.

Japan, on the other hand, is closed to intermediaries. The exception to this is international non-Japanese business. Local domestic business is on a direct basis with underwriters with no opportunity for intermediary activity. The only opportunity for intermediaries in Japan is through reinsurance broking for the major Japanese insurers.

The Japanese market is unlikely to become broker-oriented in the near term, but it may present an enormous long-term opportunity. Although alternative risk financing practices such as captive insurance companies are coming into the market, the Japanese insurance industry is very protective of its domestic market. Given the fact that there are no real "Japanese" brokers, opening the market up to brokers would mean allowing a major inflow of foreign-owned entities into the insurance industry in Japan.

The U.K. broking industry recently has been pushing for Japan to open its market, but the prospect is not for near-term success. On the other hand, the practice of Japanese corporations using brokers for their overseas business may begin to affect the Japanese market's non-use of brokers.

Korea is also closed to intermediaries, except for local Korean agents who are allowed to represent only one insurer. Foreign intermediaries are not allowed into the local market but can establish liaison offices to look after their multinational clients' interests in Korea. This situation is changing, and we understand that a license has been granted to one foreign broker. A&A also has a license pending.

With the tearing down of old insurance company pool arrangements and the allowance of foreign entities to own equity in local agencies, the Korean market is beginning to show signs of opening. As this process becomes more accelerated, Korea slowly will become a more broker oriented market. However, currently the major opportunity for intermediaries is through reinsurance of the Korean insurance companies.

In India, insurance is sold on a direct basis through four state-owned insurance companies; and there is no access for intermediaries. The only opportunity for intermediaries in the Indian market is through reinsurance of the four national companies that generally spread their business amongst four or five international brokers. However, the situation could change very quickly with the Indian government realizing the benefits of an open market and with the re-entry into the market of such major multinationals as IBM and Coca-Cola. India appears to be willing to consider a full open-market capitalistic approach in an effort to attract foreign investment and to earn hard currency. In this regard, insurance broking possibly may have a role over the next two or three years.

Europe

Most large brokers have their eyes on growth potential in Europe. While today European insurers are less "intermediary-driven" than in the U.S., in the future brokers are likely to be highly compensated as the risk management discipline becomes more widespread. In addition, while the trend toward consulting relationships has developed haphazardly in the U.S. over the past 20 years, it probably is going to penetrate Europe more forcefully.

Currently, Europe is in a downward pricing mode that probably will continue because of the lifting of trade restrictions, which are causing clamor by businesses and an increase in competition.

The emerging frontier-free single market system in Europe undoubtedly will increase the importance of cross-border

insurance coverage within commercial businesses. In this atmosphere, insurance intermediaries will play a vital role in promoting cross-border competition and in protecting consumers as they are offered a wider range of competing products in the single market.[10]

In February of this year, the European Commission took action that reflects this widely-held belief that the advice of qualified intermediaries will be increasingly important in the future. The Commission issued a directive asking EC member governments to report by the end of 1994 on the measures they have taken to lay down minimum standards for insurance brokers and to make sure that any links between brokers and insurance companies are disclosed. Germany and Denmark have no legislation covering insurance intermediaries, and the position in other countries varies enormously.

The Commission reserved the right to propose binding EC legislation if its recommendations do not produce results. These recommendations urged action in three areas:

- setting minimum qualifications for all intermediaries (these can vary according to the type of product involved),
- ensuring that consumers know whether a broker is genuinely independent of a particular insurance company (intermediaries must disclose any direct legal or commercial links with companies and publish details of how their business is spread among insurers) and
- setting up a compulsory registration requirement for all brokers.[11]

Insurance broking in the European Community is changing rapidly and extensively. Opportunities exist in Europe for brokers who already have developed a strategy to take advantage of the freedom of services. It will be difficult for smaller brokers

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[10] "EC 92 - On the Way To a Common Insurance Market," Swiss Reinsurance Corporation; Zurich, Switzerland (January 1991, p.7.

[11] "Stony Path to Consumer Choice," *The Financial Times Limited*, World Insurance Report (February 14, 1992), p. 5.

to compete unless they have a physical presence in continental Europe.

The European market is now larger than the North American market. Other than the U.K. and the Netherlands, it is considered relatively "underbrokered." This offers major opportunities.

Latin America

In Latin America, brokers will continue to be the leading creative force in the industry. It is only in the last several years that the Latin American countries, with the one major exception of Brazil, have emerged from strict tariff rating, mandatory policy forms, and in many cases, compulsory reinsurance cessions to state reinsurance monopolies.

Some of these new markets are in practice much freer than those in the rest of the industrialized world. The new liberalized markets foster competition and, as a result, creativity. This came about because brokers were able to demonstrate to local authorities that the tariffs did not adequately provide for the requirements of some national and multinational clients. At the same time, some local brokers developed expertise by working with wholesale brokers in the U.S. and London on very large state-owned companies which, for one reason or another, were exempt from the tariff schemes.

It is not surprising, then when the liberalizations came, the major Latin American brokers constituted that segment of the industry which was most aware of modern insurance and risk management practices common in the remainder of the industrialized world. Today, Latin American intermediaries are using this knowledge in the new competitive environment to maximize coverages and costs for both existing and prospective clients. Brokers will continue to be the leading creative force, at least for the commercial and industrial segment of the insurance buying public in Latin America.

Technology

The intermediary business is both a people business and an information business. It is based on the need to gather, "massage," manipulate and transfer information. Those information functions are at the heart of the intermediary's accounting, consultative and transactional functions. In each, emerging technologies are reshaping the business.

Technology already plays an important role in the insurance industry. It aids in the global analysis of investment opportunities and the placement of insurance company investment funds in many types of financial markets. In addition, advanced technology makes possible increasingly sophisticated risk evaluation, which, of course, always has been dependent on the modeling and prediction of disasters, using a large data base of historical experience. The international insurance market is also highly dependent on modern telecommunications for keeping track of global risks, safety conditions and potential disasters.

Technology also is revolutionizing both marketing and underwriting methods. For example:

- instant access to information and the ability to exchange that information quickly through on-line access to manuals, rates and electronic mail networks linking an underwriter with agents, brokers and even its insureds;
- laptop computers that make it possible for an intermediary to have access to the rating and pricing information needed to issue a policy right in the customer's office; and
- on-line searches and instant responses via electronic mail about an underwriter's posture toward a certain type of business.[12]

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[12]David A. Kocher, "Managing For Profit: Short-Term Profitability vs. Long-Term Survival," paper presented to the International Insurance Society, Inc.: San Francisco, CA (1991), p. 149.

Enhanced information technology may result in a flattening of the property/casualty cycle. Insurers will be better able to compare quickly prices to developing costs and to make timely strategic and pricing decisions.[13]

Technology also enhances the industry's ability to conduct business internationally, as the evaluation of risk and the powerful marketing tools of technology become increasingly available on a worldwide basis. Improved technological communications have made new international markets possible.

In 1991, for example, a trade association for 4,200 U.S. independent insurance agents proposed a direct link with a U.S.-based Lloyd's operation. It would underwrite initial insurance applications for specialized insurance needs (surplus lines) and give participating agents a price quotation and acceptance or rejection of a risk within 48 hours.

Other technology-led innovations include a proposal by the Chicago Board of Trade (CBOT) to develop an insurance futures market, which may become a supplement to traditional reinsurance. The CBOT has apportioned $1 million to study the project and aims to open a homeowners insurance futures market late in 1992. In 1993, the CBOT plans to launch a health insurance futures market.

The idea of a paperless global insurance industry brought about by advancing computer technologies took another step forward with four of the world's leading reinsurance organizations agreeing to establish a joint venture task force to develop common electronic data interchange standards and standard messages. The joint venture was formed to create internationally recognized standards via the United Nations Electronic Data Interchange for Administration, the Commerce and Transport Standards Committee and the American National Standard Institute.

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[13] Ibid.

The joint venture marks an acceleration in the progress of international electronic communications networking in the reinsurance and insurance fields. The envisioned standards, accessible by reinsurers, insurers and intermediaries, will allow applications in such areas as placement of business and claims on a global basis.

While utilization of technology is expected to relieve some cost pressures on brokers, the need to invest in, recruit and train people who are comfortable with advanced systems remains a challenge for industry leaders.

People

Historically, intermediaries were recruited into the insurance business based upon personal relationships, family ties and other personal links to the profession. More so than in most business, the client and decision maker was one person at a company. The need to develop personal relationships—on or off the golf course—was a key element in broking success.

As this paper has demonstrated, however, the global business and technological changes in the insurance and intermediary industries are presenting a totally different business climate. In the brokerage business there always will be a point of sale and a key decision-maker, but the tools of the trade seldom will be a putter and a club membership. As risk managers continue to become more sophisticated, intermediaries will have to recruit, invest in and train people skilled in a wide variety of disciplines. "Who you know" will give way to "what you know." The trend toward staffing from insurance carriers will lessen.

The industry needs people with qualitatively better skills and superior technical training. Although the insurance industry will have to compete for the best and brightest students with advanced degrees, the current glut of MBAs in the midst of the current global economic slowdown should make recruitment easier. A reduced head-count in financial services creates a relative advantage for brokers seeking to recruit, though this factor will be cyclical and not long-term.

While in the U.K. insurance broking is an honorable profession, in the U.S. intermediaries need to combat the perception of brokers as commission-driven "salesmen." Those global brokers who understand the future as outlined in this paper should have little trouble demonstrating the need for personnel with a variety of advanced consultative skills.

The focus on recruiting from a broader segment of society will be complemented by a significant increase in training programs and continuing education in order to "grow" intermediaries of the future. Commitments to education/training programs by large, global brokers will dwarf prior efforts. One can expect to see the equivalent of in-house universities managed by the larger firms so that they can keep pace with developments across client segments and around the world. In addition, increasing emphasis will be placed on promoting professional standards and ethical conduct.[14]

These programs will represent part of the effort to strengthen quality and excellence among intermediaries. Ironically, the importance of this goal will be underscored by the growing trend of launching lawsuits against brokers.

Litigation and Liability

The liability crisis in America, once only a concern for select business interests, has become part of the public dialogue—and with good reason. It has caused brokers to worry about the spectre of lawsuits in previously unheard of circumstances. And while the litigation explosion in the U.S., which shows signs of mushrooming offshore as well, may create certain kinds of business opportunity for intermediaries, there is a growing recognition that abusive litigation is a common place factor in daily economic life.

Litigation abuses challenge principles of fairness that the justice system is supposed to protect, damage the U.S.'s ability

[14]Robert H. Moore, "Ethics and Risk Management," Risk Management (March 1992, pp. 85-92.

to compete against other economies and ultimately erode the quality of American life. The litigation explosion and the success or failure of effort to curb it bear directly on the role of the insurance industry in the decades ahead. The trend toward expanded liability of some industries in the U.S. is undeniable and alarming.[15]

The problem stems from the distortion of a system which was set up to ensure redress for victims of genuine harm. Increasingly, the guilt or innocence of the accused bears little relevance to the disposition of liability suits. Given the potential burden of the discovery process, the cost of proving one's innocence in court can be prohibitive. When legal fees can exceed the potential judgment, the financial incentive to settle out of court and be rid of a lawsuit—whether one has done anything wrong or not—may be enormous. In addition, defendants know only too well that juries can be inclined to award large damages out of sympathy for a plaintiff.

Pressure to settle without trial is multiplied by the doctrine of joint and several liability. It holds that a defendant can be held liable for the full amount of the damage, even it that defendant is deemed responsible for only a small percentage of the damage. To exploit this doctrine, plaintiffs routinely name a number of peripheral defendants, such as outside directors and auditors, whom they assume to be financially strong and well-insured.

An ironic element of the liability environment is that the system generally fails to serve the purpose for which it was created—namely, compensating injured victims. In fact, victorious plaintiffs typically recover only 20 to 50 percent of the damages awarded them.[16] The rest goes to pay plaintiffs' lawyers and court costs.

Much of the discussion of the liability crisis has centered on product liability. Horror stories abound. For example, a textile

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[15]George Priest, "The Current Insurance Crisis and Modern Tort law," *Yale Law Journal*, 96 (1987), pp. 1534-1536.

[16]*Product Liability Verdicts and Case Resolution in Five States*, General Accounting Office: Washington, DC (1989), p. 7.

machine manufacturer that had been in business since 1830 was forced to close its doors in the 1980s after defending against 36 product liability claims. One of those claims was for equipment that had left his plant in 1895.

There is an equivalent pattern of abuse in the area of securities litigation. A relative handful of predatory law firms are bringing literally hundreds of class-action suits alleging securities fraud. The targets of these suits are companies whose stock prices rise or fall sharply. Some plaintiffs' attorneys literally scan the securities markets for a volatile stock, then sue the company for fraud—with no other evidence than the swing in the stock price. In many cases, they actually have to shop around for a shareholder willing to serve as a plaintiff.

For target companies, it's a Catch-22. If the stock goes down, they get sued because they allegedly inflated expectations. If the stock goes up, they get sued for not properly advising investors of the potential gains. They even get sued for saying nothing. Once again, the pressure to get rid of the suit without trial and get on with business can be overwhelming. An unusually high 98 percent of class-action securities fraud suits are settled out of court.[17]

All legal theorizing aside, a system that has parties paying for damages they never caused does not pass the common-sense test of fairness. The issue is not just fairness, though; the impact of excessive liability is devastating to some companies. Product liability costs for U.S. manufacturers are from three to eight times higher than those of their competitors in Europe and Japan.[18]

In 1989, 18 million civil suits were filed in state courts in this country. Of that, about 2.5 million involved contracts and wrongful acts.[19] The money American businesses spend to

[17]William Tucker, "Shakedown?" *Forbes*, vol. 148 (August 18, 1991), p. 98.

[18]R.W. Sturgis, *Tort Cost Trends: An International Perspective*, Tillinghast: Simsbury, CT (1989), p. 12.

[19]Milo Geyelin, "Quayle's Data in Proposed Reform of Legal System Called Misleading," *Wall Street Journal* (February 4, 1992), p. B7.

defend against and settle lawsuits, no matter how frivolous, is money that could have been used to hire and train workers, perform research and development, buy plants and equipment—in short, fuel America's international competitiveness.[20]

A recent Conference Board survey of chief executives argues that the threat of lawsuits caused 47 percent of companies to drop one or more product lines, 25 percent to end research programs and 39 percent to withhold new products from the market.[21]

U.S. sporting goods manufacturers have stopped making hockey equipment. It now comes primarily from Czechoslovakia, Sweden and Canada. Similarly, trampolines now must also be bought from non-U.S. sources.[22] In addition, the number of American pharmaceutical companies producing contraceptives has decreased from 13 in the early 1970s to two in 1988.[23]

A potential chilling effect on the innovation that lies at the heart of American economic growth poses frightful implications for the future of U.S. international competitiveness. The threat of potential litigation has driven many players from the field. To the extent that non-U.S. competitors filled the void, those countries reaped the benefits of jobs, growth and tax revenues.

The impact of the liability burden is not felt merely in macroeconomic terms; it can affect the average citizen's daily quality of life. The most obvious manifestation is higher prices

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[20] *Questions and Answers About Tort Reform*, American Tort Reform Association: Washington, DC (1991).

[21] See E.P. McGuire, *The Impact of Product Liability*, Report No. 908, The Conference Board: Washington, DC (1988).

[22] Larry McLain, vice president of Rawlings Sporting Goods Co. on behalf of the Sporting Goods Manufacturers Association, statement to the Senate Committee on Commerce, Science, and Transportation Subcommittee on Consumers: Washington, DC (1987), pp. 64-70.

[23] E.B. O'Connell, "The Crisis in Contraception," *Technology Review* (May/June 1987), p. 47.

for goods and services. The billions[24] per year spent in tort costs in the U.S. are ultimately borne by the consumer.

Medical care is a prime case in point. The costs of defending against and settling lawsuits make up 90 percent or more of the price consumers pay for many vaccines, for example. Lederle Laboratories, now the only remaining American manufacturer of DPT (diphtheria, pertussis and tetanus) vaccine, increased the single dose cost of the vaccine from $2.80 in 1986 to $11.40 in 1987, primarily because of increased product liability costs.[25]

The insurance industry, of course, recognizes that aggressive litigation has sensitized the client base to its insurable risks. In addition, there is little doubt that it will make brokers even more "careful" and more attentive to the need for continuing excellence.

Yet aggressive litigation quickly reaches a point of marginally decreasing returns. Few would argue that a system which exposes innocent parties to crushing liability, with detrimental effects throughout the economy and society, is serving the common good. Such a consensus among a broad spectrum of U.S. companies has been ghoroughly documented in recent years by A&A's annual Risk Management Survey.[26]

The 1992 survey marked the fourth consecutive year that respondents vented their frustration with America's civil justice system. Corporate executives are deeply concerned about finding a better method to mete out justice—one which would result in more consistent and rational court awards that compensate those who have suffered the greatest damage.[27]

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[24]Sturgis, p.1.

[25]"Impact of Product Liability on the Development of New Medical Technologies," American Medical Association Resolution 6 (A-87), Proceedings of the House of Delegates, 7th Annual Meeting (1988), p. 10.

[26]Stacy Gordon, "Work Comp Problems, Health Care Costs Worry Risk Managers," *Business Insurance* (March 30, 1992), pp. 1, 161.

[27]"National Risk Management Survey: 1992" A&A Government & Industry Affairs Inc. and Radford Associates: Washington, DC (March 1992), p. 7.

Given the fact that the majority of American legislators are lawyers, the outlook for systemic reform is not promising in the near term. Accordingly, the impact of unpredictable court awards in the United States will continue to cause fluctuations in insurance capacity and price, as well as to create exposure for businesses and organizations of all sizes.

Yet the problem is unlikely to be confined to the U.S. As other countries adopt various aspects of the American liability system, the same difficulties faced by U.S. businesses may spread abroad. In that case, these issues may need to be addressed on a global basis.

Conclusion

In summary, there is little about the business of the insurance intermediary that can be thought of in static terms. Change is evident throughout the industry and will remain fast-paced for the foreseeable future.

Pressures on the traditional brokerage business will increase as clients demand and reward a different type of value-added service. Globalization and consolidation will continue, bringing profound implications for the technology and the people employed by intermediaries.

All of these changes will take place in an environment of ever expanding liability. This will be particularly true in the U.S. where the litigation explosion is the harshest.

On balance, future worldwide opportunities for insurance intermediaries will be significant. Those in our profession who will benefit most will be those who understand that the past is not necessarily a prologue to the future.