



Cass Business School
CITY UNIVERSITY LONDON

Global Reinsurance Masterclass Series

Strategic Thinking for the
Reinsurance Industry

Masterclass 6

Intelligent matchmaking

How to maximise value from broking

Professor Paula Jarzabkowski

Dr Laure Cabantous, Dr Rebecca Bednarek, Dr Adriana Allocato



The Global Reinsurance Masterclass Series is sponsored by ESRC, WCI and IICI



INSURANCE
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Executive Summary

Changes in buyer needs and behaviours are making a profound impact on the operations of brokerage firms. Consolidation in the broking industry has been one outcome, yet further change will be needed for brokers to meet the challenges of current industry trends.

This Masterclass:

- Outlines the traditional sources of brokers' value and remuneration, and explores how current industry dynamics challenge the traditional model;
- Shows how changes in the industry mean that brokers have to devise new business models, with new links between services and remuneration – with implications for their internal structure and operations;
- Identifies opportunities for brokers to mediate with cedents both in terms of new products (such as Alternative Risk Transfer) and new capital providers;
- Highlights further implications of the changing landscape of broking for reinsurers and mid-tier brokers, and explores their strategic options.

This is the sixth of a series of seven such Masterclasses.

Even 15 years ago, the reinsurance industry could be adequately described by dividing it into two categories of business: brokered or direct. Markets like Lloyd's were fully brokered, providing opportunities for multiple small and medium-sized broking firms to generate revenue from placing their clients' programmes. Meanwhile, the big continental reinsurers largely remained in direct relationships with their clients. At the time, insurers were looking to buy relatively simple reinsurance products, based on the direct transfer of risks in a specific line of business or geographic region. The brokers were their advocates, helping to structure and place the programmes. In their role as matchmakers, looking to provide their clients with good diversification of quality capital at competitive prices, brokers rapidly followed the rise of any new capacity. For example, they took their clients and their programmes to Bermuda as it became a thriving reinsurance hub. Working for their clients, brokers expanded their networks anywhere that they could help broker a deal between capital suppliers – historically, overwhelmingly reinsurers – and their clients.

Today, the picture is vastly different. From the pool of many small- and medium-sized brokers, three main broking firms have expanded their networks globally, in the process taking 85% of the market share¹. Big brokers with large networks were indeed able to respond rapidly to cedents' demand, and to bring new reinsurers to reduce the price of capital for their clients. In addition, as they were leading the way with substantial investment in analytics, these big brokers were able to meet insurers' growing demands for

modelling and analytics. Ultimately, these big brokers put the remaining small- and medium-sized brokers under threat, and many merged with the big three, or increasingly began to operate only in small market segments.

At the same time, as reinsurers set up new divisions to operate in new markets, they turned to brokers to help them get even a small share of the business in those markets. As a result, brokers have been able to penetrate markets that were formerly largely 'direct'. Furthermore, although brokers were originally set up around a model of advocacy for their clients' programmes, capital suppliers of various kinds (not just reinsurers) have begun to consider brokers more seriously as a sales force, helping them to increase their share of the reinsurance market. Examples of this trend include the sidecar set up between big capital supplier Berkshire Hathaway and global broker Aon, to give Berkshire 7.5% of Aon's book of Lloyd's business², and the subsequent reported move by Willis to effect a similar deal, called 360 Global, to offer 20% of its Lloyd's business through a partnership with capital providers³. While these deals are not purely for reinsurance, they show the shift in understanding in large broking firms. Brokers are intermediaries able to effect deals for buyers, but also able to help suppliers to reach attractive markets.

It seems, therefore, that big is best and that the power of the global broker is unstoppable. However, size is only one element of success in an increasingly dynamic market...

¹<http://www.holborn.com/%5CData%5CSites%5C1%5Cpdfcontent%5CBestsReview-HoldingTheirOwn.pdf>

²This estimation has been made by Insurance Insider. http://www.insuranceinsider.com/?page_id=1242545

³<http://www.insurancenews.com.au/international/sidecars-re-emerge-in-lloyds-market>

Introduction: The new competitive landscape for reinsurance brokers

Traditionally, reinsurance brokers have been hired by cedents to help determine their reinsurance requirements, develop these into reinsurance programmes, and place shares of these programmes across multiple reinsurers globally. They therefore provide value for cedents seeking to buy reinsurance, by acting as advocates for those cedents.

However, as an intermediary in the cedent-reinsurer value chain, brokers also provide value to reinsurers: they help reinsurers to find a suitable set of reinsurance programmes to suit their risk appetite.

It is clear, therefore, that reinsurance brokers provide multiple services to the reinsurance market, but their major source of revenue primarily and typically still comes from just one – their placement service. This Masterclass shows that, due to changes brought about by consolidation in the primary insurance industry, this traditional source of broker revenue is being eroded. The broking industry has responded with a corresponding consolidation, but size on its own is only one part of the solution for brokers in the new competitive landscape. This Masterclass therefore addresses changes in brokers' business model that can allow them to add value, and to reap returns, in the new reinsurance market place.

THEORY GUIDE: Transaction cost economics and the resource-based view

Brokers are market intermediaries, engaged as independent contractors to arrange transactions between a buyer and a seller.

- **Imperfect markets generate profit opportunities for brokers.** Reinsurance brokers add value as intermediaries because the reinsurance market is imperfect. In a perfectly competitive market, information would flow freely between reinsurance suppliers (reinsurers) and buyers (cedents). Transaction cost theory, however, shows that real markets suffer from many imperfections. Markets are fragmented, obstructing perfect information flow, so that contracts are difficult to monitor and 'best' decisions are not possible. These market imperfections generate 'transaction costs' such as search costs, coordination costs, and costs of monitoring contracts. Market imperfections thus generate profit opportunities for intermediaries who can help suppliers and buyers to make transactions. Buyers and suppliers have to pay for the services that brokers deliver, but they also economise on often invisible transaction costs that may be expensive to incur.
- **Brokers create value through their specific resources and capabilities.** Transaction costs may be invisible because they often involve a social dimension. Brokers are able to generate value in imperfect markets because they have invested in valuable resources and capabilities that other market players lack. For instance,

reinsurance brokers create value for reinsurers and cedents because they are at the centre of trading networks, which allow them to access a wide range of organisations. This access allows them to collect knowledge and information useful when executing transactions, and foster the circulation of trades in local and global networks. Brokers can add value during contract negotiation by playing a 'bridging' position and arbitrating between counterparties.

- **The existence of brokers is based on a subtle 'make-or-buy' equilibrium.** The decision to rely on intermediaries such as reinsurance brokers is based on a comparison between the value and costs of the services that brokers deliver and the value and costs of performing these services in-house. Buyers and/or suppliers can decide to perform the work that they previously outsourced to brokers internally if that is either less costly, creates more value, or minimises the risk of information leakage. Alongside this cost-benefit analysis, market players will consider their resource-base, before deciding whether to buy services from brokers. Brokers therefore continuously need to re-evaluate and renew the value of the services that they deliver, as market players may substitute these broker services by developing their own in-house services and skills.

References

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1. The traditional broker service and revenue model

Historically, the way that brokers provide their services and are remunerated has been through a single process, from developing the programme, to placing the programme, to providing managerial support to finalise the process. Hence, as the following description shows, charging for placement has traditionally been an efficient way to generate remuneration for the entire suite of broker services provided.

1.1 The traditional brokering process

The traditional brokering process consists of the succession of phases described in (1.1.1–1.1.4).

1.1.1 Develop the programme

In helping their clients to develop the programme for reinsurance, brokers have to help identify what level, amount and type of risks to cover, and how to structure the programme. This involves deep analysis and development of the technical structure that might best protect the cedent for different levels and types of risk in the portfolio.

“We have had some successes on brokered business; brokers come up with different solutions. They work on the structure, propose something new, and maybe there is a line of business that is not properly covered where they have ideas for a complementary aggregate cover.” (Cedent)

1.1.2 Standardise the programme

Brokers package the information on the programme into a standardised submission pack, to ensure that all reinsurers wishing to supply capital are able to evaluate a particular cedent’s reinsurance requirements on an equal basis. Standardisation is an important technical service that facilitates matchmaking, because it provides a bridge between fragmented reinsurers and their collective evaluation of the cedent’s programme.

1.1.3 Place the programme

Brokers help cedents to access a diverse panel of good quality reinsurers (meaning those reinsurers with sound security and capital reserves to cover losses). Cedents acting alone may struggle to access sufficient quality capital to cover their reinsurance requirements. This may be because:

- They are particularly large and capacity is genuinely limited;

- They do not have a good understanding of reinsurers’ specific risk appetites in order to target them directly;
- Placing a programme across a large number of reinsurers requires an unfeasible or prohibitively expensive amount of leg work to be done by the cedent.

Brokers are specialists in the last two points on this list: they have built a wide knowledge and understanding of the reinsurance market and a lengthy list of contacts. Brokers use this **distribution channel** to visit, telephone and email reinsurance underwriters around the world to explain the programme. They support the programme’s analysis by acting as a go-between with the client in responding to any queries that the reinsurer has in generating quotes. They then collect the quotes that reinsurers want to offer. Good brokers maximise their distribution channel to ensure that the cedent’s programme can be offered to the widest possible set of suitable reinsurers, which helps to ensure pricing competitiveness.

“I need capacity and price is very important. This is why the broker is important; because the broker has a wide relationship with several markets. The broker knows Lloyd’s markets, the broker knows Bermuda and the broker has the contacts with continental capacity. So this means you can get the best security and the best price: this is the added value of the broker.” (Cedent)

1.1.4 Advise and negotiate

When quotes have been received, the broker advises clients in their decisions about which quotes to accept, and how to allocate shares of their programme to reinsurers. During this process, brokers use their know-how and relationships to help smooth any final negotiations about prices and shares.

1.2 Broker resources and capabilities

Successful brokering requires the broker to have a suite of capabilities and resources that are valued by cedents, typically because cedents either do not have those resources themselves, or cannot afford to deploy them to the development of their reinsurance programme.

The technical, distribution and knowledge resources and capabilities expected from brokers are detailed in 1.2.1–1.2.3.

1. The traditional broker service and revenue model (cont.)

1.2.1 Distribution capabilities

Brokers who lack extensive, high-quality distribution channels across a variety of lines of business and territories will naturally struggle. Matchmaking is at the heart of brokers' intermediation. It requires them to select the most appropriate contacts for every transaction, and negotiate between them in order to match cedents with their counterparties. Programmes can originate anywhere in the world, while the supply of reinsurance capital is fragmented across a number of reinsurance companies in different parts of the world. Brokers therefore usually need a global distribution network, covering most lines of business, in order to both find suitable cedents and also present these cedents to a wide enough selection of reinsurers.

1.2.2 Knowledge resources and capabilities

The success of a reinsurance broker is also linked to a capability to maintain relationships with both clients and reinsurers, and use them to develop a deep knowledge of the primary market and of the reinsurance marketplace. For example, many reinsurance programmes cannot be fully modelled, so contextual knowledge of the primary market is vital for preparing information, structuring the programme, and broking the deal to reinsurers. Knowledge of the reinsurance market is critical in selecting who to approach, where to find extra capacity in the market and how to leverage current market cycles to the benefit of the cedent. Brokers who under-perform in these critical knowledge capabilities, because they are not at the centre of extensive social networks, put their clients at risk, either by overpaying for their cover or ending up with a shortfall.

1.2.3 Technical capabilities

The increasing emphasis on analytics and risk modelling has prompted brokers to develop analytic expertise with an increasingly sophisticated set of tools, to assist in developing reinsurance solutions for their clients. As cedents have become more technically capable, they no longer simply delegate such analysis

to brokers. Rather, they want brokers to work alongside them and test the assumptions that they make about their portfolios and the amount of risk cover they need.

“Fifteen years ago, we spoke to clients about market trends and pricing, and about retentions, and based on that, transactions were concluded. Nowadays, clients' reinsurance buying departments are full of actuaries and analytical people. There is an interaction between what clients are doing and what we must do, so we beefed up our technical and analytical capabilities.” (Broker)

1.3 Remuneration for broking skills and processes

In the traditional broking business model, all the processes (1.1.1–1.1.4) and deployment of skills and resources (1.2.1–1.2.3) are ‘bundled’ into achievement of one outcome – the placement.

Remuneration traditionally only relates to this final placement stage. The final prices paid by cedent to reinsurer contain a percentage for brokerage, which will then be remitted to the broker as their payment for the entire service (as described above). Aspects of the broker's work such as programme development, or of the broker's ‘overheads’ such as development of technical capability, are not rewarded directly or costed separately.

As long as there is a symbiotic relationship between all the processes and the placement/payment stage, this remuneration system ‘makes sense’. However, in the following sections we illustrate how the traditional brokering process (described above) is evolving due to changes in client demand. This evolution is disrupting the connection between broker services and remuneration, so we will proceed to suggest how the remuneration model might be adjusted, the better to reflect the full range of skills and services offered by brokers.

Study Question 1

Consider the capabilities required by brokers, outlined in 1.2.1–1.2.3.

- (a) Which of these capabilities might (a) brokers, (b) reinsurers, and (c) cedents value the most?
- (b) Will a small cedent value the same capabilities as a large one?

2. Implications of the changing reinsurance landscape for brokers

Masterclass II showed that, due to consolidation, the primary insurance industry is increasingly dominated by a group of large multinational insurance companies. These global insurers have different reinsurance needs compared to their predecessors, and they also purchase that reinsurance differently.

Specifically, in these large companies, a central division at corporate headquarters purchases reinsurance for the entire, diversified group book of business. To optimise the capital efficiency arising from their diversification, they have raised their levels of *retention* of risk: they need less overall reinsurance cover because their capital enables them to cover more of their own risk internally. In addition, globalised cedents have shifted to buying bundled homogenous reinsurance products that provide complex multi-territory, multi-peril covers, discussed in Masterclass II as ‘super-risks’. These changes have altered the competitive landscape in ways that require new resources and capabilities from brokers.

In sections 2.1–2.2 we explore the impact of these changes on the broking industry, leading to ‘the broker’s dilemma’ (2.3).

2.1 Bundled products change demand for brokered distribution

The value of brokers as distribution channels to match fragmented buyers and sellers is altered by market concentration. Quite simply, there are fewer small- to medium-sized cedents looking to partner with small- to medium-sized reinsurers. Rather, there are some very large cedents looking for large reinsurance partners to support their bundled programmes – as well as a range of other substantial capital solutions to offset their risk. Hence, the matchmaking services they require from brokers have changed.

Specifically, global cedents are less reliant on brokers’ distribution services for placing the volume of their reinsurance purchase. The bundled ‘super-risks’ (see Masterclass II) that these cedents offer do need to be placed across the reinsurance industry, so they still require the broking distribution channel to reach a relatively fragmented group of small- to medium-sized reinsurers. However, the majority of their reinsurance purchase is not going to these smaller reinsurers. Rather, the biggest shares of their bundled super-risks are being placed with a handful of the largest reinsurers in the world, through a direct (not brokered) placement.

Distribution through brokers *does* remain important for global cedents; after they have completed their

major transactions themselves, it is not in their interests to develop an extensive distribution channel to place the remaining small proportion of their reinsurance cover across a fragmented market. However, from a broking perspective, the volume of business from these global cedents which goes through the placement service is reduced, so decreasing the overall financial returns to brokers of maintaining such a large distribution channel.

2.2 Global cedents have different requirements of brokers

As large cedents have centralised reinsurance purchasing, it has been financially viable for them to build up the in-house technical skills needed to develop their own reinsurance programmes. Smaller firms, often with a single reinsurance buyer, found it convenient and cost-effective to work with a broker to determine their reinsurance needs and structure their reinsurance programmes. However, large multinational cedents often have a substantial internal reinsurance division, perhaps even operating as a captive to reinsure their own local operating companies. As such, they have grown a significant internal skill base that enables them to develop their own reinsurance programmes.

At the same time, investment in technology has altered the way global cedents can access their suppliers. For example, AXA’s online platform allows them to engage with reinsurers directly from their corporate headquarters, performing the standardised distribution of their reinsurance programmes in-house rather than through a brokered process. Hence, in terms of ‘make-or-buy’ decisions, large cedents have come to a size where investing in their own resources to develop reinsurance programmes has altered their relationship with brokers about buying those services.

Global cedents still require, as their smaller predecessors did, superior technical resources from brokers. However, they need those resources not to determine or develop their reinsurance programmes, since they already have such capabilities in-house – and often at a substantive level that is well beyond the in-house capacity of many reinsurers and smaller brokers. Rather, these global cedents need a *very* technical broker to help them ‘stress-test’ the programmes they are developing in-house. The broker in this role provides a set of external eyes to help cedents think through their issues, and also potentially offers wider industry knowledge about what peers are doing.

2. Implications of the changing reinsurance landscape for brokers (cont.)

In sum, such a broker must have equal or better technical skills to those that the cedent has developed in-house, and these must be underpinned by a substantial global knowledge base that can match the global profile of the cedent. The broker is cast in more of a consultancy role, with high requirements for the technical and knowledge resources that they can bring to that consulting.

2.3 The broker's dilemma

Table 2.3 summarises the changes in the industry landscape described above, and their impact on brokers.

Change in the industry landscape	Cedent's rationale for the new strategy	Impact on Brokers' resources & capabilities
Cedents centralise group reinsurance divisions	Developing their own in-house technical capabilities (versus outsourcing them to brokers) is cost-efficient for large cedents.	Technical capabilities. Brokers have to invest in their own technical capabilities in order to provide advice to these large cedents. However, the financial value of these technical capabilities is less clear as it does not lead directly to placement and associated brokerage.
Cedents shift to purchasing bundled 'super-risks'	Large cedents can place the majority of their programmes and associated premium directly with a few large key reinsurers.	Distribution capabilities. Buyers and suppliers are less fragmented; hence the value of the broker's distribution capabilities is reduced. Brokers place (and are remunerated through brokerage) the smaller remainder of the programme. Hence distribution capabilities remain necessary but are not as well remunerated as they once were.
Cedents have a global subsidiary base	Large cedents require brokers to have a global knowledge base that matches the cedent's global profile	Knowledge resources and capabilities. Brokers are expected to have a global network. However, the financial value and remuneration of these knowledge resources and capabilities is less clear as it does not lead directly to placement and associated brokerage. Further, many brokers have not themselves fully integrated their global resources and made that knowledge easily accessible.

Table 2.3 Changes of cedent strategy, and the impacts of these changes on the value of brokers' traditional resources and capabilities

2. Implications of the changing reinsurance landscape for brokers (cont.)

In the new, global, consolidated landscape, brokers have a dilemma.

- On the one hand, they have to grow their technical capabilities to match those of their biggest clients, requiring continuous investment. Indeed, without strong technical capabilities, brokers cannot remain in business.
- On the other hand, they are not typically remunerated for these technical capabilities *per se*, but for their placement services – and the volume of business going through placement services is waning.

The new competitive landscape is dominated by large global players, who are able to place the majority of their reinsurance purchase directly with a few key reinsurers. This means that the core competence of brokers – the placement of business between

fragmented buyers and sellers – is less important for global cedents. While large cedents still clearly value brokers' abilities to provide an external set of eyes, to smooth negotiations, and to offer a level of regulatory transparency to the large deals done between counterparties, these functions do not lead to brokers getting 'brokerage' through the placement of the bulk of the programme.

Yet brokers have always been rewarded for placement, without distinguishing and being separately remunerated for their other skills (for example, consultancy support or advice on product development). The broker's dilemma – as the proportion of reward from placement declines with global cedents, while the demand for technical skills remains high or increases – is how to get an industry to value, and pay for, services and skills that have always been provided for free.

Study Question 2

- (a) In the new landscape dominated by global cedents, what has happened to demand for each of the different capabilities of brokers (outlined in section 1)? Which of the four elements of the traditional brokering process (in 1.1.1–1.1.4) now form a greater part of the broker's workload, and which have lessened? Are there new demands on brokers?
- (b) Following your analysis in (a), how have changes in the needs of cedents undermined the traditional business model of brokers and brokerage?

3. What should brokers do?

In response to cedents' consolidation, brokers have also consolidated – a process we describe in section 3.1.

Size, however, cannot be brokers' sole response to all the massive changes that have occurred in the reinsurance industry in recent years. Some of the changes indeed threaten reinsurance brokers' traditional way of creating, delivering and capturing value, suggesting that brokers' existing business model is under increasing pressure and may, perhaps, even become obsolete. In section 3.2 we suggest new possibilities to generate a better link between services, competences and remuneration.

In addition, brokers should also consider the organisational consequences of their new business models (including growth by consolidation). In section 3.3 we suggest how they must adapt the configuration of their resources and competences to their new size and their clients' new needs. Finally, in section 3.4, we explore how brokers might extend their role beyond traditional reinsurance.

3.1 Consolidation as the broker response to the changing landscape

The primary response of the main brokers has been to consolidate alongside their buyers, so attaining global scale and scope. As a result, three main global brokers, Aon Benfield, Guy Carpenter and Willis, now have 85% market share of the industry⁴. These changes have resulted in a largely oligopolistic broking market.

Meeting consolidation with consolidation in this way can add value in various ways. Consolidated brokers have rationalised and centralised many of the services from their acquired firms, such as claims processing. Their size in itself gives market share and market power. But size can also increase access to, or provide, critical mass in resources. For example:

- Global brokers have invested heavily in their technical capabilities, growing substantial analytics divisions in order to provide advice to clients who themselves have invested in increasingly sophisticated in-house technical ability;
- Global brokers also have access to knowledge of multiple markets, and can generate wider social networks, which are critical to their potential matchmaking skills. Provided that the consolidated global brokers can retain knowledgeable staff and integrate the knowledge

flows arising from their acquisitions, they are well-placed to provide advice and support for multi-territory, multi-peril product bundling.

Essentially, global brokers have the scope to provide global cedents with a global service.

However, size on its own is insufficient to meet the changing demands of the market in ways that increase the bottom line. In particular, large brokers with a relatively singular revenue stream are prone to the price competition effects of oligopolistic markets. That is, in order to protect their market share, or take market share from rivals, the big three reinsurance brokers have resorted to price-based competition in order to retain large or valuable clients.

Such price-based competition comes through discounting the brokerage charged. Discounting is particularly fierce when cedents invite tenders for 'locked-in' services, known as Request-for-Proposals (RfPs), in which the successful broker that wins the tender will have the cedent's program to place for some three years. In such cases, there is fierce competition to demonstrate the wealth of technical, distribution and knowledge resources that the broker will bring to the cedent, and, in order to ensure that they are the favoured candidates, this is often provided at a reduced brokerage.

Brokers have thus increasingly competed on the price for which they provide their distribution skills, throwing in their other skills – which are expensive to acquire and maintain – as a 'sweetener', to close the deal. This has had the effect of devaluing or at least making it difficult to cost the value of those additional skills that are not part of the placement service.

3.2 Getting remunerated for what brokers actually do

Reinsurance brokers' historical business model, as outlined in section 1, consists of offering a bundle of services to their clients through the placement process. The cost of each service (for example analytics) is not explicit, as payment for all services is received through brokerage. This approach has traditionally been an efficient way to be remunerated, but it currently limits brokers' ability to be paid for the new technical services that they provide to cedents.

As brokers increasingly act like consultants, it might 'pay' to get remunerated, in part, as a consultancy firm would – though a fee-for-service model, complementing brokerage. Two approaches are outlined overleaf.

⁴<http://www.holborn.com/%5CData%5CSites%5C1%5Cpdfcontent%5CBestsReview-HoldingTheirOwn.pdf>

3. What should brokers do?(cont.)

- **Adopt an itemised approach to services.** One solution is for brokers to unbundle the services that they deliver to cedents. Instead of offering a ‘package’, in which all services are provided in return for brokerage, brokers could offer an itemised list of services from which cedents could pick. For example, assessing reinsurance exposure, advising on and structuring the reinsurance program, developing and distributing the submission pack, collecting quotes, and so forth. This itemised menu would encompass brokers’ technical, distribution and knowledge capabilities and break them down into specific parts that could be priced individually.
- **Differentiate between a range of bundled services.** Given that many services are connected, full itemisation in the manner described above may be difficult. Another option would be to differentiate between a range of bundled services. Reinsurance brokers could mimic telecoms companies and provide a set of three or four standard packages, tailored to the needs of three or four types of clients, with different forms of remuneration. For example, smaller clients could opt for the full (traditional) development, placement and management package, which would be paid for in brokerage. Larger cedents, meanwhile, might opt for a technical advice and partial placement bundle, with a different remuneration structure involving both a fee for advice, and a proportion of the placement in brokerage. Finally, some cedents may choose a consultancy and claims management service, which would involve a fee, potentially indexed to the number of hours worked, rather than brokerage.

In summary, brokers need to be multi-faceted in the way they generate revenue from their clients. They might have made some small steps in this regard, but they remain largely trapped in old business models.

3.3 Changing the business model and organisational structure

Either of the strategies outlined in section 3.2 would require a clear understanding of the costs and value associated with each service in order to be able to price the package offered to clients. Indeed any rational step away from the outmoded ‘traditional’ brokerage model requires such an understanding. Brokers, big or small, need to undertake substantial internal analysis to better understand where value is created in their organisations, where costs come from, and how services cross-subsidise each other.

Ultimately, this internal analysis may lead reinsurance brokers to re-configure their resource-base and change their organisational structure, to better reflect the value of each service. For example, brokers could restructure around autonomous profit and loss centres, either charging for services directly to external clients, or recharging internally to reflect the real costs and value of each part of the business model. This might lead reinsurance brokers to realise the extent to which their value proposition and business model have changed, and to evaluate whether some tasks, such as analytics, actually generate as much or more value than placement.

3.4 Extending the broker’s role beyond traditional reinsurance

Brokers’ value depends on exploiting market imperfections in order to offer resources in which others are not willing to invest. Here we suggest that brokers exploit their role as intermediaries to match cedents with a range of counterparties and products beyond those of traditional reinsurance.

3.4.1 Brokering the substitutes

Global cedents are increasingly looking for a range of cost-effective sources of capital. As shown in Masterclass I, the competitive dynamics of the reinsurance industry are affected by growth in Alternative Risk Transfer (ART) products, such as catastrophe bonds. These products are usually perceived as substitute products for traditional reinsurance, yet they provide brokers with opportunities; helping them to innovate and reinvigorate their business model. Reinsurance brokers need to capitalise on substitute products.

From a broker’s perspective, ART products are less labour-intensive to distribute because they do not require a traditional broking service. They do require a distinct skill set, but brokers who do not yet have the specific capabilities required to broker ART products can acquire them on the market at a reasonable cost. Nonetheless, there are a number of regulatory and organisational issues that brokers need to take into account before being able to distribute ART products. In particular:

- Any player dealing with ART products is separately regulated, and needs to have passed requisite exams. This type of regulation currently limits the ability of brokers to distribute ART products, and puts small brokers particularly at a distinct disadvantage;

3. What should brokers do? (cont.)

- Brokers will need organisational structures that foster cooperation between advisory teams, those specialising in ART and traditional products, in order to share knowledge and enable a combined approach to clients;
- The brokering of ART products might be an opportunity to develop or 'test' a more comprehensive fee-for-service model.

3.4.2 Brokering new entrants to the market – new capital providers

Brokers could also direct their attention as intermediaries to other parties, beyond their traditional network of insurance and reinsurance companies. For example, a broker could also become the key intermediary for providers of capital who are tempted to enter the reinsurance market but lack the technical skills and market knowledge to do so. The broker could partner with these potential entrants to lower their cost of entry to the reinsurance market by simply providing them with access to the broker's book of placed business.

By becoming the natural gateway for non-traditional capital providers wanting to enter the reinsurance industry, brokers can further maximise the value of their distribution channel. Recent examples of innovative partnerships with capital providers include Berkshire Hathaway's deal with Aon Benfield, through which it is allocated a 7.5% quota share of all business which Aon places in Lloyd's; or Willis' similar, proposed 360 Global deal⁵. In such deals, the broker's primary focus has turned away from relationships with cedents towards the capital supplier. These deals allow brokers to capitalise on their investment in technical skills and distribution networks, albeit in ways that seem to compete with traditional reinsurers.

The changes in business model that have been discussed in sections 3.2 (regarding revenue streams) and 3.4 (regarding product innovation and diversification) are summarised visually in Figure 3.4 below.

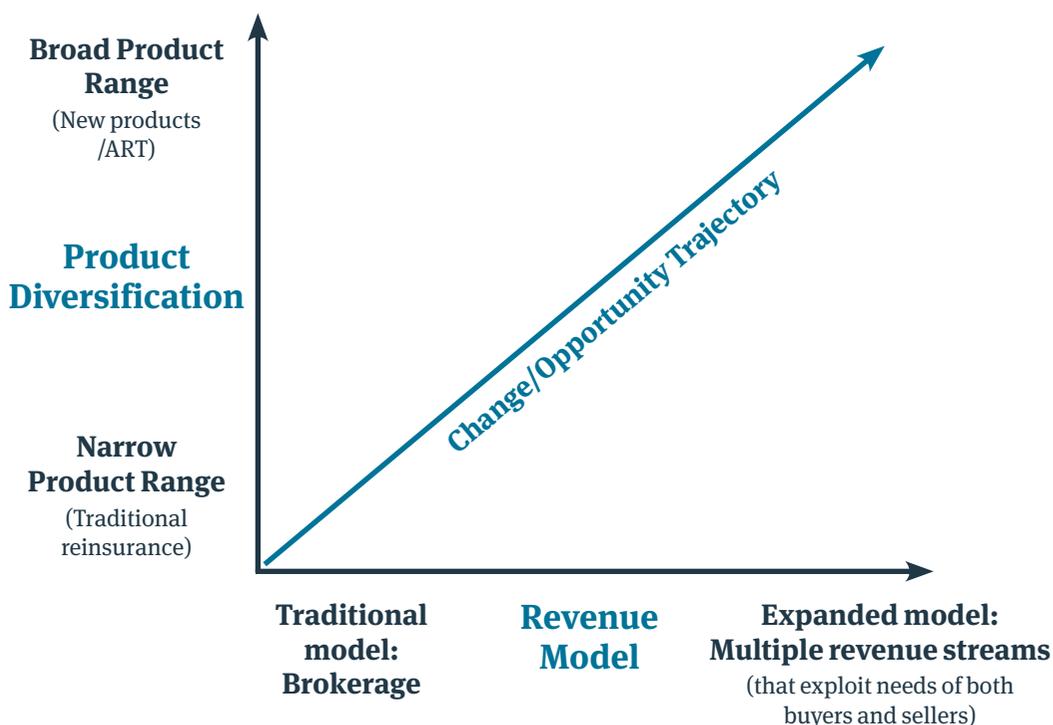


Figure 3.4 Changes in brokers' business model: product diversification and revenue streams

Study Question 3

Sketch out how a broker might divide its operations into a few separate profit centres, charging both internally and externally for services.

- What difficulties might have to be overcome in such a separation?
- What particular capabilities are required in each of these profit centres?

⁵Artimis (2013, March) 'Berkshire Hathaway providing capacity for Aon's new Lloyd's based sidecar' <http://www.artemis.bm/blog/2013/03/13/berkshire-hathaway-providing-capacity-for-aons-new-lloyds-based-sidecar/>; Insurance Insider (2013, May) 'Willis poised to launch major 20% London sidecar, Global 360' <http://www.insuranceinsider.com/willis-poised-to-launch-major-london-sidecar-facility-global-360>

4. Conclusions: Future trends

4.1 Erosion of mid-tier brokers

The leading global reinsurance brokers have increased in scale and scope, and invested heavily in technical resources and capabilities, in order to be able to meet the expectations of their cedents. These large established reinsurance brokers are now in a position to develop collaborations with new market players (e.g. new providers of capital), and to offer new services to existing market players (e.g. reinsurance companies). This is not possible for small brokers who do not have the technical infrastructure or global reach to ‘match’ the demands of large global cedents, reinsurers or new market players.

One viable solution for such smaller brokers would be to compete on quality, rather than price. To do so, they will need to develop a clear niche strategy and focus on a narrow subset of clients (most likely with products that are more geographically local in nature), where their high-quality specialised services are valued. Specialisation could be based on line-of-business or on geography.

Alternatively, as already evidenced with the sale of Towers Watson⁶, these brokers are ripe targets for acquisition as part of further industry consolidation.

4.2 Implications for reinsurers

As Masterclasses I and III showed, reinsurers are under considerable threat from changes in cedent buying behaviour, and from increased competition

from substitute products and new entrants. Indeed, some of the responses from brokers which are suggested in this Masterclass – such as assisting new capital suppliers – are likely to exacerbate these challenges for reinsurers.

However, in meeting these challenges, traditional reinsurers need to see brokers as a sales force for their capital, helping them to best deploy it to the actual need in the industry. This might include helping reinsurers to:

- Expand into ART products;
- Innovate with traditional reinsurance products to make them more attractive in the face of substitutes;
- Penetrate new markets.

Here global brokers could provide both consultancy and practical services to develop new products and to access new markets. These are functions for which small and medium-sized reinsurers lack in-house resources and capabilities, and yet which they cannot justify developing under their current revenue models.

In general, the impact of current and future change in the broking industry needs to inform reinsurers’ strategic thinking and forecasting regarding their own future. Masterclass VII will consider the implications of the rapidly changing landscape – in broking and in many other areas – through a scenario planning exercise.

Study Question 4

Historically, brokers have been cedent-focused; this Masterclass has outlined some ways in which brokers’ might find value in stronger relationships with players on the other side of the deal – capital suppliers. Reinsurers are of course the traditional capital supplier.

- (a) In what new ways, not covered by the ‘traditional’ broking model, can brokers operate as a ‘sales force’ for reinsurance capital?
- (b) What capabilities of brokers might a medium-sized reinsurer wish to use?
- (c) How might such partnerships differ depending on the size of either the broker or the reinsurer?

⁶<http://www.intelligentinsurer.com/news/lt-acquires-towers-watson-s-reinsurance-business>

List of Global Reinsurance Masterclasses

- Re-Think reinsurance: How to shape your future through a strategic understanding of global market forces
- Fit for purpose? How to tailor reinsurance products to insurance industry lifecycles
- Winning the game: How to identify reinsurance rivals and spot growth opportunities
- Be a better reinsurer: How to align structure, knowledge and roles for operational excellence
- Strategic reinsurance relationships: How to evaluate information and build trust
- **Intelligent matchmaking:** How to maximise value from broking
- Imagining the future: How to stay ahead in the reinsurance game through scenario planning

The aim of the Global Reinsurance Masterclass Series is to support (re)insurance and broking companies in analysing their position and improving their competitiveness during a period of global change. They are based on in depth analysis of a global reinsurance data set, supplemented with analysis of secondary data and findings from complementary industries.

Each masterclass functions as a standalone module that can be used on its own or in conjunction with other masterclasses.

Cass Business School
106 Bunhill Row
London EC1Y 8TZ
T: +44 (0)20 7040 8600
www.cass.city.ac.uk



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In 2002, City University's Business School was renamed Sir John Cass Business School following a generous donation towards the development of its new building in Bunhill Row. The School's name is usually abbreviated to Cass Business School.

Sir John Cass's Foundation

Sir John Cass's Foundation has supported education in London since the 18th century and takes its name from its founder, Sir John Cass, who established a school in Aldgate in 1710. Born in the City of London in 1661, Sir John served as an MP for the City and was knighted in 1713.