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Insurance brokers – their evolving role

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It is a very great honour to have been asked to give the Derrick Cole Memorial Lecture. Alison Green has outlined the career of a remarkable man in the insurance market. It was my privilege to have known him not only for his great experience of the industry but also for his many kindnesses to me over the years when I have worked with BILA.

I have chosen to speak of insurance brokers and their evolving role mainly as Derrick was a great insurance broker with a real commitment to bringing the market and lawyers together, but also because it is an interesting study of a profession that has had to evolve continually with the way the market has developed.

Perhaps more than ever today we appreciate the dynamic effects of markets and the need for any profession to identify the characteristics of that profession that will enable it to survive and prosper in dealing with the changes that will inevitably occur. The lawyers amongst you might reflect on how much of what I will say could, with a little adaptation, be said of the legal profession. That profession is itself in the process of undergoing very profound changes as a result of market forces, the removal of restrictions on the ownership of law firms and the new business models that lawyers can adopt.

Brokers have always played a central role in the insurance market. Why? It is, I think, because of the characteristics that have moulded and, in the longer term will continue to mould, the profession of the insurance broker.

History and analysis show that there are a number of identifiable characteristics which have been essential to the evolution and will continue to be essential to the evolution of the profession. These are first, skill and competence second, integrity and loyalty to the assured, third, reasonable remuneration, properly disclosed, fourth, a clear understanding of the relationship with the underwriter and fifth, the need for adaptability in the vicissitudes of the market. Let me therefore turn to look at those characteristics first by considering episodes in the development of broking over the past few centuries.

The early days

How ancient the profession is is not clear to me, but in a statute of 10 Richard II they were referred to as Broggars or in Latin *Abrocarii* or *Brocarii*. Certainly by Elizabethan times there were about 30 brokers who were engaged in the writing of insurance policies of marine insurance near the Royal Exchange. We know that because in 1574 an associate of Sir Thomas Gresham, the great financier, a Mr Richard Candler, tried to obtain a monopoly over the making and registering of policies of insurance through an Office. The Company of Brokers considered they were "likely utterly to be undone" by the monopoly

and petitioned against it. They made the point that might well be made today that it would be an infringement of the liberty of every good citizen if such a monopoly were imposed because any person might make his own insurance and write his own policy. It appears that the protests of the brokers, who were joined by notaries in this protest, did not prevent the establishment of the Office for which a patent was granted to Richard Candler. However some sort of compromise was arrived at under which the profession continued to be able to make and write policies of marine insurance, for it was in marine insurance that the profession developed.

The emergence of a specialist and well paid profession

By the beginning of the 18th Century the business of insurance broker had become more specialised. That appears to have been the case because no specialist underwriters had yet developed. The services of a broker were needed by merchants in London who wished to place insurance and by merchants abroad who wished to take advantage of the London market. They then earned 5% on the original premium and 10% discount on the final balance of the account. Balances were not in practice settled until some 6 to 12 months after they were due but this could at the time possibly be justified by the fact that, as underwriters did not have to make a deposit, the delay in settling balances provided some measure of security to the assured.

They are described by Hatton in his "A New View of London" published in 1708 as follows:

> "Offices that Insure Ships or their Cargo are many about the Royal Exchange, as Mr. Hall's, Mr. Bevis's, etc., who for a Premium paid down procure those that will subscribe Policies for Insuring ships (with their Cargo) bound to or from any part of the world, the Premium being proportioned to the Distance, Danger of Seas, enemies, etc. But in these Offices 'tis customary upon paying the Money on a Loss to discount 16 per Cent."

It seems to modern ears extraordinary that a loss was paid at a 16% discount to brokers but it is perhaps evidence of the vital service they then performed.

It may be that these very high fees that were earned can be seen as giving rise to the attack made by Mr John Weskett in 1781. As Wright and Fayle comment in their "*A History of Lloyd's*", the main objects of his attack were the "folly of underwriters, the chicanery of brokers and the dishonesty of the assured" as well as the "daily attendance of no less than four or five attornies at Lloyd's coffee house" and the failure to use arbitration. It is a reminder of how little in fact changes, as such sentiments were often expressed exactly 200 years later in the many turmoils that engulfed the market in the 1980s.

1810: the skill required of a broker

But whatever criticism might be made of the market, there is no doubt that the professional skill required of a broker was recognised. In the Parliamentary debates in 1810 when there was an attempt to establish by a number of merchants a new company which Lloyd's saw as a threat to its business, Mr Marryat MP, who led the Parliamentary opposition to the attempt, spelt out the skills required of brokers and underwriters.

> "I am aware," he said, "that the occupations of an insurance broker and underwriter are generally considered as demanding but very superficial attainments; but a candid investigation of the subject will prove this idea to be erroneous. An insurance broker can only qualify himself for his business by considerable study and application. He must learn how to fill up policies of every description, with all the various clauses adapted to every possible circumstance. He must be able to make accurate declarations of interest, so as to cover the parties in case of loss, and yet not expose them to the payment of any unnecessary premium in case of arrival. He must know how to make up complex statements of average and partial losses on every species of merchandise, and on the various principles applicable to every different case. He must be informed of the current rates of premium on every voyage, in order that he may be enabled to transact the business intrusted to him to the best advantage; and he must be well acquainted with the character of the different underwriters, to guide him in the selection of names he takes upon his policies."

If this were adapted from its marine insurance context, it would not be an inapposite description of the skills required of the modern broker.

It was perhaps these skills which justified the brokerage that brokers were then earning. By this time the broker received 5% on the original premium and 12% discount on the payment of balances. During the course of the Parliamentary hearing it was admitted that this represented nearly a quarter of the underwriter's gross profits. But this did not mean that brokers were wealthy men. Some thought that what they were paid was not too much for "labour, the agitation of mind, the perpetual vexation" of a broker's business. A partner of John Julius Angerstein, the underwriter and Chairman of Lloyd's whose art collection formed the cornerstone of the National Gallery, said that few brokers retired with great fortunes:

> "The utmost that I recollect do not live beyond this establishment; two maids and a manservant."

When he was told this did not apply to Mr Angerstein's fortune, he retorted that that was made more as an underwriter than as a broker.

The nineteenth century: innovation and expansion

During the 19th Century brokers were generally small firms of two or three partners who generally handled marine insurance with a circle of connections in London and provincial sea ports and correspondents abroad for whom they placed risks in the London market.

Illustrative of the importance the position that brokers by then held is the fact that the 8th edition of Sir James Alan Park's seminal work on Marine Insurance published in 1846 required a chapter on brokers. There had been none in previous editions. The editor described brokers as those who undertook to perform their duties with integrity, diligence and skill and as "persons of great respectability and honour and to whom the merchant is able to look with confidence for the proper performance of his duty …".

Although fire and life insurance companies had placed business through agents, they had until this time made little use of brokers. However the use of brokers increased for, as the London insurance market, and in particular Lloyd's, expanded its non-marine business, brokers took on the business and flourished. Towards the end of the 19th Century, the great broking houses emerged. One example of this can be seen in their entry into re-insurance business as that developed during the latter part of the 19th Century, as can be seen by the fact that the Swiss Re, established in 1863, first entered into a treaty with an English company in 1864. By the end of the century and the early part of the 20th Century there had emerged firms whose names were familiar until very recently. The emergence saw in 1906 the formation of an Association of Insurance Brokers and Agents.

The involvement in underwriting

As part of the innovation of the latter part of the 19th Century and much more in the 20th Century brokers began to take a much greater interest in actual underwriting, although, as I have said, Angerstein was both broker and underwriter. It is clear, at least from the end of the 19th Century with the expansion of brokers overseas and the bringing back of business to London, that brokers not only formed their own underwriting operations but participated as members of syndicates at Lloyd's. In his evidence to the Committee on the Lloyd's Bill in 1982 Mr Robert Hiscox demonstrated how when Price Forbes & Co (one of the origins of Sedgwicks) was formed, Mr Price became an underwriter with risks passed to him by other parts of the firm. The same can be seen in Derrick's firm of Willis Faber where when Mr Spence, the chairman at the turn of the century, retired he was recognised not only as a good broker, but also as an able and successful underwriter. But it was not only brokers who entered the underwriting business, but Lloyd's underwriters formed broking businesses to bring them business – the most well known being Cuthbert Heath who formed a brokerage in 1890.

By the 1930s and 1940s it appears that the incidence of taxation had the consequence that underwriters sought to capitalise the goodwill of their agencies and brokers became a ready source of that capital.

The reasons for steady growth of the ownership of underwriting agencies at Lloyd's and the benefits were summarised in the Cromer Report which had been commissioned by the then Chairman of Lloyd's, Sir Henry Mance, in 1969 to consider the future of Lloyd's:

> "249. A broker is anxious to secure as much business as possible and his weight will, therefore, normally be thrown against any effort to restrict the volume of Lloyd's business on too narrow a view of profitability. Many brokers are also men of great force and energy and infuse useful qualities into any organisation they control. A broker through an agency company can provide capital for any expensive equipment required by the syndicate.

For his part, the broker secures a substantial return from the agency especially if underwriting becomes profitable again. He controls the use of substantial syndicate funds. He can use clerical and computer resources to best advantage, as between the broker's business and the underwriting business."

The report went on to conclude that there was a substantial body of Lloyd's that believed that broker control was undesirable and should be discouraged, if not brought to an end. The report concluded that there was a conflict of interest which could not be ignored.

> "253. That the Lloyd's market developed on the scale that it has and enjoys the world wide reputation that it unquestionably does enjoy is due in very large part to the energy and ingenuity of Lloyd's brokers and to a not inconsiderable degree the foreign brokers that Lloyd's brokers have cultivated through the years. There can be little question that the Lloyd's underwriting syndicate and the Lloyd's broker are essentially complementary to each other in forming the Lloyd's market as a whole. Although complementary, and this is a cardinal point, they are not interchangeable. The broker is the agent of the insured and in any conflict with any underwriter should put first the interest of the insured. He should not even adopt the role of an arbiter in a conflict unless this can be seen to be to the advantage of the insured. If a conflict were to arise between an insured and an underwriter who happened to be an employee (even indirectly) of the broker to the insured the problem is most difficult. But, short of conflict of this kind, we find it difficult to accept that, in exercising judgment of what business to accept and what to refuse, an underwriter who is an employee of a broker-owned agency can at all times be wholly impartial. That conscious effort is made to achieve this, we are left in no doubt, but the very fact that this is the case leaves doubt as to the degree that it is attainable under the day to day stresses and pressures in a market. In so far as any influence might be exercised it would be to encourage an

> underwriter to accept risks he would, if independent, refuse, so that the names of his syndicate could be carrying more than in the free judgment of the underwriter were desirable."

The report recommended that brokers ought to reduce their interest in underwriting in the long term interest of their broking business, but this was a matter for discussion between Lloyd's brokers and underwriters.

That report was not published, but events in the insurance market and in particular in Lloyd's saw a return to the issues of the relationship between brokers and underwriters in the report by Sir Henry Fisher commissioned by Sir Peter Green and published in 1980. That report, perhaps typical of a lawyer of that generation (who incidentally remains the only judge to have resigned from the High Court Bench shortly after his appointment) was over-dogmatic and over-legalistic in its approach. To a more modern eye, it displayed insufficient understanding of the operation of free market economics. Sir Henry Fisher recommended that there should be compulsory divestment of the ownership by brokers of underwriting agencies on the basis that the interests of the assured and the interests of the names were separate and distinct and were sometimes in conflict. It was, in his view, unacceptable that brokers should have power to control an agency which owed legal duties to names. The insured were at risk that the broker would not be whole-hearted in looking after the assured's interests if he had a financial stake in an agency.

The result was the Lloyd's Act of 1982 which brought about compulsory divestment. It was a radical though, from an economic viewpoint, somewhat simplistic solution to what is a much more complex issue. It is not the least surprising that the solution was abandoned in what, looked at in the context of the centuries of the market, was a relatively short period of time.

Failures of integrity

The nature of that more complex issue relating to the relationship of underwriter and broker can be seen as what lay behind major failures of integrity in the market, some of which attracted public notoriety. These scandals included Unigard, Sasse, Savonita, Ashby, Tonners, Oakley Vaughan, David Gale Underwriting Agencies, PCW and the Personal Accident spiral.

An analysis of each of these would show that the cause of the problem was not ownership links between underwriters and brokers nor the lack of regulation, but weak underwriters, a failure to control terms of binding authorities, a failure to understand that business was being written for commission and, at the root, a failure of integrity on the part of brokers. I cannot emphasise too much how great that failure of integrity was. Each scandal highlights the need for a real understanding of how the relationship between insurance broker, the underwriter and the client should be managed and how that relationship is dependent on the five characteristics of the profession of broker that I identified at the outset.

Let me now then turn in a little more detail to those five characteristics.

1. Skill

It is self evident, in my view, that a broker needs that level of skill and learning to which Mr Marryat alluded in 1810 as much today as ever. For the placing broker the skills include – a mastery of the law relating to insurance, an ability to draft clearly and with precision, an ability to explain to the assured their duties and then to understand the nature of the risk to be insured so that a fair presentation can be made to underwriters and a knowledge of the underwriters. Other skills are needed for the claims broker.

Today perhaps the most difficult aspect of the skill of the placing broker is to apply in practice what is required by the law of disclosure. In a piece Derrick Cole wrote for the BILA Journal in 1998 entitled, "Are the judiciary re-writing insurance policies and do they have a sufficient knowledge of what actually happens in the market place?" he observed:

> "… I expect the underwriters to ask sensible questions and send the broker away if he cannot provide the answers (as I have been sent away on several occasions). I would not expect the underwriter to ask technical questions where the broker has a duty to explain, for example, the combustible nature of the goods stored, which may not be in the public knowledge …
>
> … I believe the law should recognise that placing a risk is a two-way discourse and not simply a matter of the broker making a presentation and the underwriter saying yes or no! …"

The balance between making a fair presentation of the risk and an underwriter understanding sensibly what is put before him and asking questions is in any specific case fact sensitive. I think experience has shown, however, that the courts have not been insensitive to the dangers that can arise from placing too much emphasis on the passive position of the underwriter to merely receive a fair presentation. I think Derrick Cole was right to say that in essence the placing of the risk should be a dialogue as the broker in putting the risk to the particular underwriter has to put that risk not only on the basis of what a reasonable underwriter would expect, but one that takes into account the subjective position of the particular underwriter.

2. Integrity and duty of loyalty to the assured

The hallmark of any professional person, which must be seen as such, is that person's integrity. This is again the quality required of the insurance broker, just as of any other profession, mentioned by Park and the lack of which was the root cause of the numerous scandals to which I briefly referred.

The most obvious legal exemplification of the duty is his duty to act in the interests of his client to the exclusion of other interests. There have been suggestions, as for example expressed in 1981/2 by David Palmer, Chairman of Willis Faber, when he said in a

presentation to BILA, that he had never taken too literally the legal concept that the broker solely represents the interests of the client. He said that when he first came to the market the broker was 60% for the client and 40% looking after the market, the underwriter. The position might have changed by the time he was speaking so that he thought under the pressure of consumers and fair trading the pressures of competition the percentages had slipped nearer to 75/25.

Despite the eminence of the maker of those observations, there are, I think, two things to note. First the timing of the observations; they were made at the outset of the major problems of the market; I doubt whether they would be made today. Secondly, acting in the interests of one's client does not require the broker to ignore other factors. He must not drive so hard a bargain that the market in which the broker is operating ceases to be one he can use again; it is in the interests of the client that there remains a market in which business can be placed in future years. But it does emphatically mean that he must see that the interests of the client for whom he is acting are protected; for example, the broker cannot use his position to place easy business at more generous rates that disadvantage one client in the expectation that by doing so he will be able to place a difficult risk for another client.

But the more interesting question is how is such integrity maintained? Until the 1960s, it was clear that the internal structures of the market, its small size, the fact that people knew each other and the authority of persons such as the Chairman of Lloyd's acted as the mechanism through which those who failed to adhere to the integrity could more easily be identified.. Some of the scandals to which I have alluded showed that that system had broken down and it was not therefore surprising that first self regulation on a formal basis and then statutory regulation became necessary. Insurance brokers, like almost every other profession, became subject to this regime. It is too early to tell whether regulation will prove an effective means of maintaining integrity and, if so, what form it should take – detailed rules or principles. Experience has shown that it is still essential to rely on a personal judgment of the individual with whom one is dealing and, if possible, the swift and sure ruin of those who transgress the basic principles of integrity.

3. Reasonable remuneration properly disclosed

Any profession, if it is to attract those of ability sufficient to carry out the work with skill and care, must provide for reasonable remuneration. One of the other obvious problems of the market in the 1970s was the poor payment for some essential task. When I used to go to the City to advise or to appear at an arbitration in the 1970s, it was indeed remarkable to see the very low rates of pay being advertised for those who wrote policy wordings when it was self evident that a number of problems that were then occurring had arisen because of the lack of skill by those employed in writing policy wordings. The only beneficiaries have been the succeeding generation of lawyers.

The question of remuneration raises the issue as to how the broker should be remunerated and whether the amount that he is remunerated by the underwriter should be disclosed to the client. The traditional view was very clear. It had been the practice of the market for many years that the broker was remunerated by the underwriter; those were the terms upon which brokers traded. Everyone understood that it was the mechanism for paying the broker.

However, the way the system of remuneration operates is contrary to modern standards of transparency. It was therefore interesting to observe that earlier this year a court in Hong Kong, looking at the question of whether the payment of commission by an insurer to a broker was prohibited by the prevention of bribery ordinance, that the duty of the broker was confined merely to disclosing the fact that he was remunerated. I do not believe this position is sustainable or that it will continue to be upheld. I would very much hope that the broking community takes the lead in ensuring full disclosure of commission earned, including any incentives.

4. A clear understanding of the relationship to the underwriter

I have already touched on aspects of the broker's relationship to the underwriter in relation to the duty of disclosure, the issue of integrity and remuneration. But the nature of the relationship with the underwriter is historically what has distinguished the insurance broker from other types of broker and that is why it is so important that both underwriter and broker understand the position.

The difficulties arise when a broker is placed in a position where he acquires two or more principals in relation to the same transaction. One instance is where the broker in seeking to place cover for the original assured cannot do so unless he does so by arranging a reinsurance package that those who subscribe will take up; provided the broker does not abuse the relationship by breaching the duty of integrity by churning or creating a spiral, this should not cause any real difficulty. More problematic, though pragmatism dictates its use, is the grant of a binding authority to a broker. The potential for conflict of interest is obvious. Its extensive use in Lloyd's was one of the principal arguments of those who opposed divestment of managing agencies who made the obvious point that the grant of binding authorities to a broker produced a greater conflict than ownership of an underwriting agency where there was a separate entity and collection of individuals that did the underwriting. However the market at Lloyd's could not conduct certain important parts of its business without the use of binding authorities and pragmatism took the place of the supposed principle.

Although the position of the insurance broker is in these respects unusual for brokers, there is no reason of actual principle why a conflict of interest cannot be managed. Any lawyer engaged in litigation has to manage his duty to the court and his duty to the client; the duties often conflict, but are managed by very clear rules such as those requiring a lawyer to draw to the attention of the court any case which is adverse to his argument for his client, even if the other side has not found that case.

There is no reason why such conflicts cannot be managed in insurance broking by (1) clear contractual arrangements, (2) disclosure and transparency and (3) active management of the contractual arrangements. My experience of the abuses that occurred in the 1970s and 1980s in relation to binding authorities arose because (1) the contracts were hopeless; (2) there was a lack of transparency and (3) often an abdication of any management by the underwriter which allowed the dishonest and unscrupulous to commit those abuses.

In any developed market where the consumer is not involved, experience has taught me to be very sceptical of those who insist on detailed regulations and do not leave the market to develop its own mechanisms to manage conflicts by adherence to basic principles.

5. The need for adaptability

It is I trust self evident that the profession of insurance broking is one that is in my view essential to the operation of the market. It has over the centuries adapted and prospered by adherence to the core characteristics I have attempted to outline.

The change in the markets and the continuous development of new products and new ways of doing business at an ever increasing rate is a fact of life. During his life, Derrick Cole saw that one of the vital links that had to be maintained was ensuring the lawyers and the judges understood the market and that the law developed to reflect those changes. Whereas a judge of the nineteenth and early part of the twentieth century could be reasonably confident that little had fundamentally changed in the market since his time in practice, today the position is very different. In respect of the financial markets, the Financial Markets Law Committee provides annual seminars for the judiciary. We are fortunate that BILA, in particular through the energy of Derrick Cole, has provided that vital updating link. That is vital, for our law of insurance still is significantly based on the application of principles decided in the 18th and 19th centuries. The development in this way, provided judges understand the market, has in particular provided a modern workable law. Clearly some of the provisions of the Marine Insurance Act 1906 need amending, but I am not over optimistic of time being found for changes outside the sphere of consumer protection.

May I reciprocate for the assistance given by the market by simply observing that whilst the products and mechanisms of the market might change, the fundamental characteristics of the insurance broker must not. It is vital that those are not lost and in particular the lessons of history, including in that the terrible times of the 1970s and 1980s, are not forgotten when those values are inculcated into the new generation. Maybe the generation in the 1970s and 1980s (which saw the scandals to which I have referred) would have done well to recall the values of earlier generations and the lessons of what goes wrong when they are not followed.