Better Knowledge Enhances the Insurance-Purchasing Decision

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What Nonprofits Can Learn from Recent Headlines

The expression, “knowledge is power? comes to mind when reading about the recent civil suit filed by New York Attorney General Eliot Spitzer against the world’s largest insurance broker. According to *Business Week*, the suit alleges that the insurance broker, “engaged in bid-rigging, price fixing and accepted payoffs from insurers.” (See www.oag.state.ny.us for information about the suit.)

By using legal and financial resources that few, if any, insured organizations could have mustered, New York’s attorney general has brought forth credible evidence that major players in the insurance industry have taken actions that undermine the integrity of the insurance transaction. In the wake of the Spitzer lawsuit inquiries into similar practices were launched by Spitzer’s counterparts in Minnesota and Connecticut. Additional inquiries have been spearheaded by the state attorneys general or insurance departments in California, Florida, Illinois, New Jersey, North Carolina, and Ohio.

What’s It All About for Nonprofits?

What do these recent revelations, civil suits, and ongoing investigations mean for nonprofit insurance buyers? For most of us, it is a real challenge to gain a true sense of how the industry works, and to understand the terms of the policies and the relationship between the coverage and our organization’s insurable exposures.

While many nonprofit leaders understand and appreciate the valuable role that insurance professionals (agents and brokers) play with regard to helping nonprofits obtain appropriate coverage, the current scandal has shaken the confidence that buyers have in their insurance industry counterparts. Too often a nonprofit buyer’s relationship with an insurance provider is not built on mutual trust. Although large nonprofits with an insurance or risk management expert on staff may have a different perspective, most nonprofit CEOs and CFOs continue to bear direct responsibility for designing and implementing their organization’s insurance program. These executives repeatedly express frustration about their experiences as customers of the insurance industry. Small nonprofits have a difficult time finding an agent or broker willing to help them, but those that locate an insurance advisor often find the advisor falls short of delivering the coverage needed or requested by the nonprofit.

At the heart of the current scandal is the technical difference between brokers and agents: brokers often tout that they are representatives of the insured, while insurance agents are representatives of the companies with whom they have a contractual relationship. Some state insurance departments have taken steps to eliminate the legal distinction between agent and broker. For many years the Nonprofit Risk Management Center has been cautioning nonprofit leaders that in states where the legal distinction between agent and broker remains, that distinction is largely a technical one, and that in the real world the following is true:

- Both agents and brokers depend on customers (including nonprofit customers) for their livelihoods — satisfying the customer is essential to succeeding in the business; and
- Both agents and brokers enter into contractual arrangements with insurance markets (companies, carriers, etc.) that may influence the advice and assistance they provide to nonprofit consumers.

For example, when an insurance professional tells a nonprofit buyer “I was only able to obtain one quote for your account,” the statement may be true, but the agent may only have access to one insurance company that writes nonprofit organizations. Thus, the nonprofit buyer may assume — seemingly quite reasonably but often wrongly — that the agent had access to all of the markets competing for nonprofit accounts and this was the only company who agreed to bid.

Also, when a broker strongly recommends that a nonprofit purchase its coverage from company A versus company B, it might be because the broker will receive a higher commission or be eligible for incentive compensation from company A, which would call into question the broker’s duty of loyalty to the insured.

According to H. Felix Kloman, author of *Risk Management Reports* (www.riskreports.com), “Contingency commissions of any type, and even the commission system itself, where the seller, not the buyer, remunerates the intermediary, and where the intermediary professes to represent *solely* the buyer, corrupt a relationship that must be built on complete trust. I have no beef whatsoever with the payment of commissions of all types to those who present themselves as *agents* of the seller.” (*Risk Management Reports*, November 2004)

Compensation arrangements that are unknown to the commercial insurance buyer may, unfortunately, affect the recommendation that an agent or broker makes to his client. Therefore, the more knowledge the nonprofit insurance consumer has of the agent or broker, the better the outcome of the decision to purchase will be. While it is true that some categories of nonprofits don’t have access to many insurers, in most cases, an insured will have at least some choice of carriers for various coverages. Knowledge of the agent’s or broker’s true market access and compensation arrangement can be factored into the review of the proposals. In many cases a nonprofit leader will be surprised by how little the insurance agent receives in compensation for placing the nonprofit’s account. Knowing the amount of compensation is helpful as you consider what services you expect and require from your agent. It is feasible that one earning minimal compensation may not be financially capable of investing the time with you that you require.

The Post-Scandal To-Do List

When you read the latest news stories about the insurance industry’s current challenges, you may wonder what if anything you should be doing differently. The Nonprofit Risk Management Center recommends the following nine steps to help you meet your fiduciary duty to all of the various stakeholders in your organization, protect your nonprofit’s vital assets, and hopefully improve the confidence you have in the insurance professionals you rely on for sage advice and practical help to ascertain appropriate coverage.

1. *Seek Help From a Nonprofit Specialist* — Whether you are working with an insurance agent or broker, make certain you understand if your advisor is a nonprofit specialist. Ask what percentage of the firm’s “book of insurance” is represented by premiums paid by nonprofits, and the total number of nonprofit organizations served by the agency or firm. Some specialist agencies report that 70 percent to 99 percent of their clients are nonprofits, while others (generally the larger agencies and brokerages) report a smaller percentage but still a large number of nonprofit clients. Also ask for examples of the types of nonprofits handled by the firm. Ask for references from other nonprofit clients. There is no substitute for working with an insurance professional who is in position to effectively market your account to underwriters and provide value-added services to your organization
2. *Obtain Independent Help* — If your nonprofit relies on an insurance agent or broker who also serves on your board, commit to eliminating this serious conflict of interest as soon as possible. Either your

insurance advisor should step down from the board, or you should find a new agent or broker. Having access to an independent insurance advisor is essential to fulfilling your fiduciary duties to your organization

3. *Ask About Market Access* — Ask your insurance agent or broker to disclose the markets (insurance companies, carriers, etc.) with which they have placed nonprofit accounts during the past one to three years. Determine with which of these insurance companies they have contractual agreements or relationships. Your broker may claim to have access to the entire insurance industry, but when pressed to list the markets where the agency has placed nonprofit accounts the broker may have only been successful placing nonprofit accounts with one company. Your agent or broker may have appointments with only one or more carriers that sell coverage to nonprofits. Market access is a key factor in evaluating the suitability of a broker or agent that your nonprofit will rely on for insurance assistance and expertise. Size is not determinative: never assume that a larger agency or brokerage means better market access or “leverage? that will be used on your behalf
4. *Require Disclosure of All Compensation Arrangements* — Insist that your insurance agent or broker disclose the amount of commission received and any contingent/incentive arrangements when they present quotations for your consideration. Knowledge of compensation agreements may prove helpful in evaluating the quotes you receive
5. *Consider a Fee-Based Arrangement* — If the commission your agent or broker receives from any of your insurers is substantial, consider whether a separate and distinct fee, paid by your nonprofit, would better serve your interests. Under such a fee-based arrangement the nonprofit buyer negotiates a fee for services with the insurance professional based on the work and services that will be provided. Once such an arrangement has been agreed to, the dollar amount that would otherwise be due as commission is subtracted from the total premium paid to the insurance company. Some nonprofit leaders have told us that they prefer to write a “single check” to pay for insurance. Paying the broker separately may be an administrative inconvenience, but it reflects a deeper knowledge of the compensation arrangement. Why not pay a reasonable fee for the services you receive, rather than permit that broker’s compensation to be based solely on the price you pay for coverage?
6. *Evaluate the Services You Receive and Estimate the True Value of These Services* — As you evaluate the work performed by your employees to determine its benefit to the mission, you should evaluate the performance of key contractors to your nonprofit, including your insurance agent or broker. In our book, *Coverage, Claims and Consequences: An Insurance Handbook for Nonprofits*, we present a sample Broker/Agent Report Card that suggests a scoring system based on responsiveness, timeliness, credibility, commitment, claims handling, accuracy and results
7. *Put Your Insurance Program Out to Bid* — One of the most important lessons from the scandal is the importance of true and actual competitive bidding, since the broker named in the Spitzer lawsuit is accused of presenting inflated and false quotations. The suit points out that relying on a single intermediary (agent or broker) to obtain competitive bids for you doesn’t assure that your account has been put out to bid in a comprehensive manner. True competitive bidding occurs when two or more agents or brokers compete for your business. The preferred way to go about the process is to assign markets to each bidder, which avoids two or more agents approaching the same company on your behalf. Ask each agent or broker bidding to identify the three markets they want to approach and then make the assignments based on the feedback you receive. While it’s true that the incumbent agent or broker’s feelings will be hurt when you put the program out to bid, doing so is the only way to assure yourself (and your board) that the coverage you’re buying and the price you’re paying for that coverage are competitive. Furthermore, the best agents and brokers in the business will admit that the markets they work with will often “sharpen the pencil” and offer better terms and pricing when they know they are competing against other insurers. Keep in mind that for most nonprofits, putting an insurance program out to bid every year is impractical. Consider putting your insurance program out to bid at least every three years, depending on your circumstances and satisfaction with your current providers.
8. *Recognize Conflicts* — Conflicts of interest exist in every profession; the insurance industry is no different. It works against you to ignore the conflicts and disincentives that come into play when you purchase insurance. When compensated by commission, an agent has an inherent conflict, since the firm may receive more commission when you (the insured) pay a higher premium; however, most agents recognize that if they do not do well for their client, another agent or broker will. An insurance system based on commission compensation also leads many agents to shy away from small organizations that generally require the most help on insurance matters, yet generate small premiums, yielding negligible commissions.
9. *Focus on the Big Picture* — It is easy to become lost in the insurance forest and focus on a single, towering tree: the premium quoted or the agent’s compensation. While it is absolutely critical to consider these factors when evaluating the coverage available to your nonprofit, it is most important to focus on

the big-picture issues. Don't shortchange your organization by simply purchasing coverage from the lowest bidder without giving the coverage itself and the carrier a closer look. Don't breach your fiduciary duty by choosing insurance company A over insurance company B because of the disclosed broker compensation arrangement. Focus on the primary issues, which include:

- Does the proposed coverage address the crucial, insurable risks facing your nonprofit?
- Is the coverage sufficiently broad to meet your needs? Is the deductible or retention set at the appropriate level?
- Are you purchasing limits of liability that bear some relation to the risks you face?
- Are you buying coverage from a company or other provider that is financially stable and in position to pay claims when they are made?
- Will you receive the services and support you need from this provider?

In Summary

An example from Canada seems especially enlightening. According to Advisen, a provider of strategic information services to the insurance industry (www.advisen.com), by the end of the year brokers in Ontario, Canada, will begin disclosing their commissions and bonuses at the time they place coverage on behalf of a buyer. In addition, insurers in Canada have agreed to post broker and agent compensation arrangements on their Web sites. Although there is no evidence that U.S. companies will follow suit, major players in the insurance industry are working hard to respond to the scandal by implementing new confidence-building measures.

In the weeks and months ahead, insurers and insurance professionals will continue to look for ways to restore confidence and dispel the notion of widespread wrongdoing and unethical practices. In the meantime, nonprofit insurance buyers can and should also take some action in the wake of the widening scandal. As a nonprofit leader responsible for buying insurance, you should 1) commit to learning more about the coverages that you have purchased to protect your nonprofit's vital assets, and 2) try to bring to light additional information that will improve your decision-making with regard to insurance coverage. With better information about the structure of premiums and with insight into the relationship between your advisor/intermediary and the companies offering coverage to your nonprofit, you will be in the strongest possible position to make an informed purchasing decision that will serve your organization well.

Melanie Herman is executive director and George Head is special advisor at the Nonprofit Risk Management Center. The Center provides free technical assistance to nonprofits on a wide range of subjects, including insurance matters. We welcome your phone calls and emails about the issues addressed in this article or any insurance or risk management matter facing your nonprofit. Melanie Herman and George Head may be reached via e-mail. As a reminder, the telephone number at the Center is (202) 785-3891.

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