www.pwc.com/us/insurance

top issues

The three C's:
How consolidation, customization and collaboration will continue to impact commercial brokers in 2018

January 2018

The three C’s:
How consolidation, customization and collaboration will continue to impact commercial brokers in 2018

As we first noted in our 2014 publication, Broking 2020: Leading from the front in a new era of risk[1], trends reflecting larger macroeconomic forces have been fuelling a contentious debate between brokers and underwriters on compensation, leading to a “war of words” in 2017 that saw leading players on both sides to invest to reinforce their market positions. The same trends are also driving increased customization of products, increasing reliance on direct-to-consumer models, and greater economies of scale for an increasingly large number of market participants. Collectively, we categorize these trends into the “three C’s” of consolidation, customization and collaboration.

Consolidation: We continue to see overall consolidation of the brokerage market; Conning tracked over 450 transactions through October 2017. This activity compares favorably to 537 transactions in 2016 and a longer term annual average of 414 transactions from 2011 to 2015. Looking forward, the factors that are driving consolidation and greater levels of operational efficiency include a low interest rate environment, the presence of alternative capital providers, and ongoing demand for expanded broker capabilities.

Customization: Overall, the desire for more localized market knowledge and custom products is a strong and recurring trend, with historically strong insurance hubs such as Lloyd’s recognizing the increasing need to meet local demands. For brokers, the need is clear: provide local knowledge coupled with global scale to rapidly place risks across geographies.

Collaboration: Technologies such as Blockchain have the potential to fundamentally transform insurance processes providing both efficiency savings and greater levels of information to both brokers and their customers. Depending on its ultimate implementation, it is possible that brokers could operate within a fully

1 Available at http://read.pwc.com/i/391105-broking-2020-leading-from-the-front-in-a-new-era-of-risk.

electronic process or be innovated out of it (i.e., be replaced by electronic platforms and algorithms for many categories of risks). Ultimately, the broker's place in the insurance lifecycle likely will remain despite increasing automation, but for those risks from which an intermediary can be removed, disintermediation will occur. For example, we have seen innovative carriers such as Hiscox offer a direct to consumer model for small commercial risks.

Trends that impacted the personal lines market in prior years are beginning to impact commercial lines, with risk managers looking for more customized products and technology-driven innovations for even the most specific product classes.

Consolidation – The commercial brokerage market has experienced continued consolidation, with the top ten brokers generating 2.5 times more revenue than the next 90 brokers in the market (Conning Insurance Segment Report: Property – Casualty Distribution, p. 2). We believe that three trends are driving this M&A wave:

1. **Alternative capital –** Alternative capital providers (e.g., hedge funds, private equity) have continued to play a role in accelerating consolidation, lured by consistent revenue streams (many brokers have renewal rates in the 80%- 90% range), as well a systemic diversification outside of the debt and equity markets. With ongoing low investment yields, the presence of alternative capital is expected to continue influencing the market. Their "hunt for yield" has raised broker multiples, and created a feedback loop of higher valuations and higher deal volumes.

2. **Stagnant Revenue –** Despite some short-term hardening as a response to catastrophic events in the second half of 2017, we believe generally favorable loss experience and historically high policyholder surplus will continue to pressure pricing for the foreseeable future. As a result, premium pricing could remain soft across most commercial classes, thereby restricting both premium and commission growth.

   This ceiling on commission growth will challenge brokers of all sizes to improve their internal cost structures, particularly for back-office processing, which can represent well over half of their operating costs. They are increasingly able to do this through technology initiatives that automate standard and/or low-value processes, as well as introducing better analytics and sales tools to increase

3. **Demand for Local Market Presence –** As risk managers struggle with increasingly complex risk exposures, they are looking for brokers to provide enhanced services across their enterprises. While this would seem to benefit the largest brokers, we believe there is a growing appetite for a seemingly contradictory skill-set: a global footprint with enhanced local knowledge – which puts pressure on brokers to expand their footprint in new or existing locations.

   For brokers whose operating model is "hub and spoke" with branch offices remitting central placement to a global office, we believe smaller specialist firms that can provide immediate service on the spot will continue to compete strongly against brokers that are unable to provide comparable, enhanced local support. In fact, this expectation goes beyond the brokerage side of the value chain to insurers and even placement markets such as Lloyd's, which are increasingly challenged to provide more efficient and localized service.

Related, PwC's 2014 "Risk Buyer Survey" noted that risk managers ranked price-driven change as the third most likely reason to switch brokerages, below service capabilities and geographic reach. This strongly implies that brokers must continue to expand their service offerings while simultaneously offering local market knowledge and global scale.

Three trends will continue to fuel the broker consolidation wave: alternative investors bringing new capital to the market, stagnating broker revenue driving efficiencies of scale, and demand for greater local market presence.

Customization – Current operating models need re-assessment as insurance buyer demands change. Beyond price, buyers are looking for a variety of choices and flexibility when working with their insurance brokers. The demand for choice has begun to split the commercial market, with buyers falling into two behavioral groups:

- **Insurance as a service:** These buyers look for comprehensive risk management solutions and view insurance as a set of services (risk transfer, risk management and risk mitigation) that can lower their overall exposures to loss.
- **Insurance as a product:** These buyers view insurance as a product and transaction, and therefore look for the best combination of price and ease of doing business.

"Insurance as a service" buyers look for bespoke risk management services beyond placement. Their carriers need to provide risk advisory, value-added services such as site audits and close interaction with the company's internal finance and accounting departments to align their insurance portfolios to their risk exposure. A relevant example is Hartford Steam Boiler providing site inspection and engineering consulting as a complementary service that moves beyond risk transfer into a recurring advisory role.

On the opposite end of the spectrum, "insurance as a product" buyers look for a variety of insurance choices and the ability to compare and build more modular insurance products as needed. These buyers look to on-line solutions for their purchases and want to easily understand products for which robo-advisors and comparison sites are becoming competitors to traditional brokerages.

While still nascent, we believe there are a number of new market entrants that can challenge incumbents in the "insurance as a product" space:

- **Direct to consumer carrier:** Insurers such as Hiscox offer a consumer-facing website that allows SME markets to quote select liability exposures directly.
- **E-brokerage:** Internet brokers such as Coverhound allow purchasers to submit quote information on-line.
- **Peer to peer:** Start-ups like Lemonade and Bought by Many may displace the entire insurance model with peer-to-peer risk pooling.

Consumers are increasingly looking for more customized buying experiences and products from all industries. Commercial risk buyers are no different, and as buyer expectations change, brokers will need to align their business models to their targeted buyer profiles.

Collaboration – In the US alone, Conning has estimated that 3,000 insurance companies and over 30,000 agents and brokers serve the insurance market. Looking forward, Blockchain could enable common data sharing across this fragmented market. Two possible scenarios could play out, broker-centric v. direct-to-consumer.

In either model, Blockchain has the potential to transform the (re)insurance value chain, including:

- **Risk Management –** Blockchain could be combined with other Internet of Things products (such as RIFD) to track the transport of high value goods.
- **Policy Validation –** Blockchain implementation could support policy validation in real-time, minimizing coverage validation and improving subrogation/recovery capabilities. Steps to create insurer-to-insurer (I2I) communications have already begun, with the carrier-led "B3i" initiative between Aegon, Munich Re, Zurich, SwissRe, and Allianz to link the numerous insurer-specific use cases for Blockchain.
- **Reinsurance –** Complex, multi-layer reinsurance contracts could be managed on a common Blockchain, allowing participants to automatically track and managed ceded/assumed premiums and losses.

In addition, as we noted in Broking 2020, one way brokers can create value in this environment is to become risk facilitation leaders. This role would connect various industry leaders, (re)insurance leaders, and governmental officials on select risks (e.g., cyber) to discuss holistic risk management solutions. Brokers seem ideally placed to facilitate such discussions, which would provide them an opportunity to move beyond risk transfer and become a collaborative partner in their clients' operational success.

PwC's 2014 Risk Buyer Survey supports this idea: 67 percent of risk managers considered their brokerage firm a "trusted advisor," versus 46 percent who simply viewed themselves as a "placer of coverage" (Note: respondents were able to select multiple choices, resulting in values greater than 100 percent).

New technologies such as Blockchain could provide the insurance industry a unique opportunity to collaborate. How these technologies will impact the industry remain to be seen, but forward-thinking (re)insurers are already establishing collaborative initiatives to establish proofs of concept.

Implications

- Faced with the “three c’s” of consolidation, customization and collaboration, we believe brokers have an opportunity to implement proactive changes before these trends cause even more disruptive change(s). Changing buyer demands will require brokerages to reassess their operating models in order to confirm they provide the correct balance of enhanced local market knowledge and scale efficiencies.

- Industry consolidation will further concentrate market power. Smaller brokerages need to determine the appropriate business strategy for a market where the top ten brokerages produce 2.5 times revenue as the next 90 firms.

- Brokers could position themselves to compete in price-sensitive “insurance as a product” markets and/or establish risk management/advisory offerings to serve “insurance as a service” buyers.

- Emerging technologies such as Blockchain have the potential to disrupt insurance placement and policy management processes. Brokers should establish a plan to leverage these emerging technologies to manage or avoid disruption from new market entrants.

Contacts

Richard Mayock
Global Insurance Brokerage Leader
+1 646 471 5090
richard.mayock@us.pwc.com

Jamie Yoder
US Insurance Market Leader
+1 773 255 2138
jamie.yoder@pwc.com

Francois Ramette
Principal, PwC Strategy&
+1 773 612 7952
francois.ramette@pwc.com

Marie Carr
Principal, PwC Strategy&
+1 312 298 6823
marie.carr@pwc.com

Matthew Wolff
Director, PwC
+1 847 650 7348
matthew.wolff@pwc.com

Joseph Calandro, Jr.
Managing Director, PwC Strategy&
+1 203 906 6595
joseph.calandro@pwc.com

www.pwc.com/us/insurance