MS17/2.2: Annex 3

Market Study

Wholesale Insurance Broker Market Study

Final Report: Annex 3 – Financial and profitability analysis

February 2019

Annex 3: Financial and profitability analysis

Introduction

1. The Wholesale Insurance Broker Market Study seeks to understand whether competition in the London broking industry works effectively. To do this the market study focuses on several areas of potential concern, one of which is the extent to which market power may be affecting outcomes in the market.

2. To assess the competitive landscape, we have considered a range of evidence from several different pieces of analysis. This paper lays out the details of the financial and business analysis that feeds into our overall assessment of the competitive landscape of the London wholesale insurance broking sector. The main findings of this annex are discussed in chapter 3 of the final report.

Objectives of our profitability analysis

3. There are 2 main reasons we have undertaken a profitability assessment. First, an analysis of profitability is part of understanding the business models of brokers that place large complex risk into the LIM. Understanding firms' business models helps us to understand firm incentives and how firms compete. In doing so, we looked at the relationship between revenues, costs, and profits across different brokers. We examined how the relationship is affected by the size of the firm, the type of risks it places and the extent to which these relationships change over time.

4. Second, we wanted to understand what financial performance suggests about how competition is working in the wholesale insurance sector. For firms subject to less competitive pressure we would expect profits to be high and sustained. The financial performance of firms representing a substantial part of the market can be a useful indicator of competitive conditions in this industry.

5. This annex provides a summary and explanation of our analysis. The structure is as follows:
   - **Data:** we provide an overview of the scope of our sample, which firms were selected and why. We also discuss some of the issues with the data we received and the conditions and limitations this places on our analysis.
   - **Firm revenues:** we provide an overview of firms' revenue sources. In particularly we look at the extent to which placement and non-placement revenue feature in firms' business models.
   - **Firm costs:** we provide a breakdown of firms' cost bases and look at the implication for brokers' business models.
   - **Market profitability:** we provide an assessment of market profitability across firms and how profitability changes over time. We look primarily at firms' profit before tax though we use a range of different measures to test the sensitivity of our results.

- **How profitability is affected by scale:** we assess the effect that scale has on broker' financial performance and explore the extent to which different levels of financial performance may indicate different levels of competitive pressure.
- **How profitability is affected by risk class:** we examine the financial performance of different types of risk placement and the extent to which the type of risks brokers place is a driver of profitability.

6. Our financial analysis is based on a sample of insurance brokers selected to be representative of the market. Using a representative sample minimises the burden on industry. Around 60% of our sample were selected primarily due to scale. Larger firms represent a larger proportion of the market and are more likely to cover a wide range of market segments, for example servicing a wide range of different client types or placing a wide variety of risk classes. We also selected around 40% of our sample from small firms to gauge profitability at all levels of the industry. In choosing these firms, we deliberately selected a mix of firms servicing as wide a range of market segments as possible.

Our data set

7. Our financial data come from 30 insurance brokers and covers the years 2012-2017. Firms were asked for 2 quantitative data sets. The first related to firms' total broking business as defined by the data request. The second was a breakdown of the first data set into a set of different risk categories. In both cases, we asked for data regarding revenue, costs and balance sheet data.

8. In 2017, the firms in our sample generated revenue of £2.7bn and profit before tax of £626m. We also use operational data on GWP from 2012-2016. In 2016, the firms in our financial sample placed GWP of £24bn. In 2017, the LIM accounted for approximately £60bn in GWP.[1]

9. Our investigation focused on the process of competition in the market for brokerage, the placing of large, complex, or specialist risks with multiple underwriters within the LIM. In addition, we were interested in business related to facultative but not treaty reinsurance.

10. Our scope therefore required an extremely specific set of financial data. Most firms in our sample found isolating this business extremely difficult. Some brokers, especially larger firms, will commonly service the entire supply chain, from dealing with the client to the placement of the risk. Isolating 1 part of that chain proved challenging for some firms. Some wholesale brokers only act to place risk but engage in lines of business falling out of scope.

11. Only around one-third of respondents could provide assurance that the data related solely to our market definition. Most of these firms' entire business lay within the scope of our study. A few firms provided data that had been adjusted to fit our scope.

12. The remaining firms were asked to explain what lines of business fell outside our scope but were included in the financial data that had been submitted. The main issue raised by respondents was that a proportion of risk that would otherwise have fallen in scope was placed outside the LIM, in other wholesale markets such as Singapore. Firms reported that they had no reason to account for these business lines separately and

[1] "Overall total for the London Market of £59.905Bn", IUA London company market Statistics Report, October 2018. Available at: https://iua.co.uk/IUA_Member/Publications/London_Company_Market_Statistics_Report.aspx. This figure includes treaty reinsurance and overseas business managed by London operations. And London Matters (2017), The competitive position of the London Insurance Market https://www.londonmarketgroup.co.uk/lm-2017.

so the data could not be provided. Our inability to isolate these data means we have had to be cautious in interpreting our results.

13. The second most common issue was where brokers identified business segments that fell outside scope. In most cases, these have been easier to identify and quantify. In the majority of cases, these additional lines of business are either relatively small or have been submitted as part of the segmented accounts, for example treaty reinsurance, allowing for an adjustment of firms' submissions.

14. The comparability of whole-firm and risk-segmented datasets between firms raises some issues which we have had to build into our analytical approach.

15. At the whole-firm level, granularity was relatively consistent between firms, though for a very small number of firms not all costs were reported. Our use of weighted averages plus a review of the materiality of excluded costs in other firms' financials suggests this is unlikely to alter results materially.

16. Firms found providing segmented data more challenging with around a third of firms in our sample being unable to do so. Our segmental data analysis is therefore based on smaller sample, primarily excluding some smaller firms. For those that have submitted data, different methods of central cost allocation made comparability of data complex. In addition, the use of different risk segments has made direct comparison of risk class profitability more difficult. We discuss how this has altered our analysis below.

A note on presentation

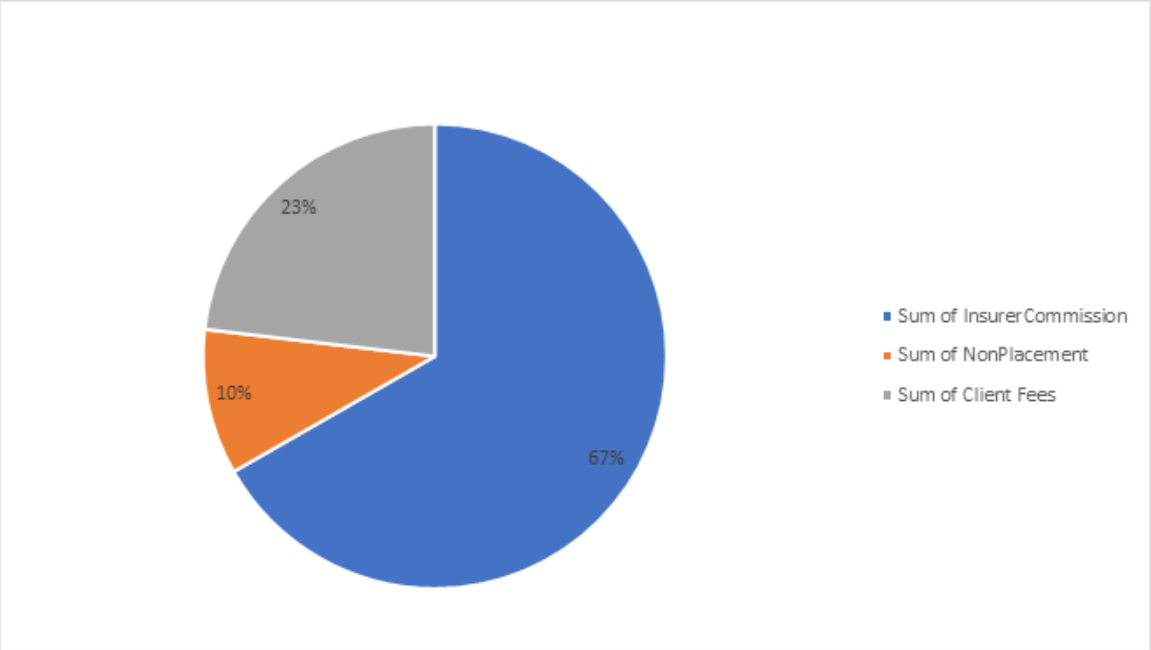
17. Though the bulk of our analysis has been completed on a firm-by-firm basis, we typically show averages to reflect financial performance across the industry and to protect confidential firm information. Where results are notably different between different firms we also note ranges and levels of variance in the sample data.

18. Averages for percentage variables, such as margin (operating profit divided by revenue), are typically calculated by using the sum of input variables for all firms (in our example the sum of all firms' revenue and the sum of firms' operating profit) then calculating the percentage variable (in our example operating profit margin). We refer to this as the weighted average. Where this could introduce a bias, we have checked the sensitivity of our results using geometric and arithmetic averages.

Brokers' revenue

19. Brokers generate the bulk of their income by placing risk with underwriters in the LIM. Placement of risk can be charged for via commission, a portion of the premium received from the insurer, via a flat fee charged directly to the client or some combination, or either. Revenue derived from the placement of risk represents the majority of firms' revenues. Figure 1 below shows a weighted average of broker income sources.

Figure 1: Sources of broker revenue (2016)



20. Our data request also asked firms to include revenue that was related to or enabled by the firm's wholesale broking business. We found that, whilst the majority of firms provided non-placement services as part of their business, only a small number of, typically larger firms, split this out.

21. These larger firms were also more likely to offer non-placement services related to data analytics where the firm offers an analytic function to insurers providing management information to allow them to develop future business strategies. These firms also offered more traditional non-placement services related to their role as outsourced risk specialists, for example claims consultancy, that other brokers were choosing to roll into their brokerage fee.

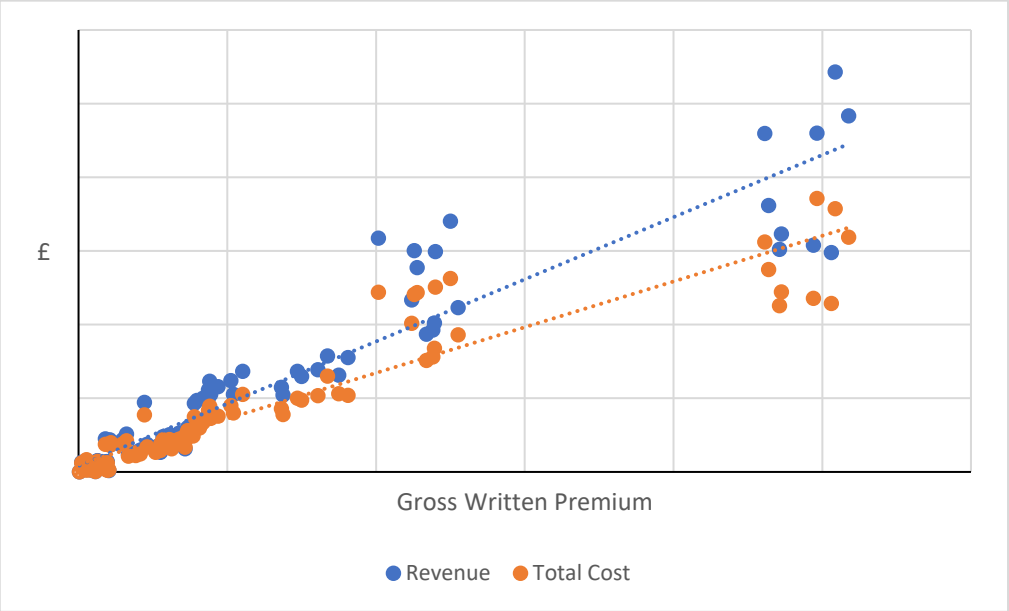
Brokers' business models

22. Our analysis shows that brokers generate revenue by selling their expertise and their ability to administer the complex process of risk placement. Brokers are remunerated through commissions and fees on placement of a risk but some brokers, typically larger organisations, also sell their expertise more broadly earning revenue from non-placement sources such as risk assessments and data analytic services.

23. This expertise focused, human capital driven business model is reflected in the cost data. A weighted average of our sample suggests that around 55% of costs are staff costs. The proportion of cost due to staff varies across our sample. With over three-quarters of firms in our sample having staff costs that account for 55% of their total costs, and a third having staff costs that accounted for 65% of total costs. We note that, for smaller firms, a higher proportion of total cost is due to staff. This would suggest that as a firm grows it requires a larger, and more costly, infrastructure to operate.

24. We found there was a very strong correlation between GWP, revenue and cost.

Figure 2: Relationship between GWP, Revenue and Cost



25. The link between size and revenue is in part due to the prevalence of insurer commission as the main revenue stream for brokers. This uses an ad valorem commission structure where revenue grows proportional to the size of the risk placed. The larger a firm grows in actual terms, the greater its absolute profitability.

26. We also looked at the correlation between cost per pound of GWP placed by the broker against GWP itself. We found that at a firm level there was some evidence of economies of scale; that is, as a firm's GWP rose, cost per pound of GWP placed fell.

27. Despite this we did not find any obvious correlation in the sample as a whole. We tested for several different relationships in the data, including stratifying the data using dummy variables to represent groups based on size of GWP. We found these variables to be statistically significant. One possible explanation is the existence of tiers of firms within our data sample.

28. This would fit with our analysis of firms' qualitative response to our request for information. Our analysis suggests that the type of risk a broker places is governed by their expertise. A large part of this expertise is the network of relationships the broker maintains. Clearly, this is driven by positive reinforcement: a broker with expertise in Marine risk maintains relationships with clients facing Marine risk and with underwriters that are interested in this type of business. This seems to create a market in which some brokers can find it difficult to compete beyond a certain niche.

29. If this were creating a market where brokers were only pursuing contracts commensurate with their size, it could explain the stepped nature of cost/GWP regressed on GWP. For firms only planning to pursue a certain size of contract there would be no need for wider non-staff infrastructure since the scale necessary to profit from increased economies of scale would not be present. For example, the infrastructure maintained by the very largest firms, along with their wide range of expertise, allows them to compete for and service contracts of a different scale and scope than a small niche broker. Similarly, the size of the firm will determine the size of contract worth pursuing. For large firms, a small contract requiring bespoke

servicing may not generate a sufficient contribution to overheads. To a smaller, more specialist firm, the same contract may look more attractive.

30. Our business and financial analysis provides some insight into the incentives of firms and a possible explanation of their business strategy and how they incentivise staff. First, firms are clearly incentivised to grow. We see this in the analysis of absolute and per GWP revenue and cost. This makes sense when considering brokers' business models where costs are essentially fixed in the short run. The broker must be careful to maintain service quality but any additional placement has very high marginal profitability. This is borne out by looking at the key performance indicators (KPIs) used by brokers to incentivise staff; a mix of revenue, profit and quality measures. The result is that, for an individual broker, it is always incentivised to win new business, indeed some brokers actively encourage this through their remuneration KPIs.

31. A firm's incentives are similar. They, too, are incentivised to grow the business whilst maintaining quality. Both firms and their staff may be incentivised not just by short-term profitability but by the future revenue flows that can be attracted if a new contract further demonstrates the firm's expertise. Despite this, however, firms may find they are restricted in the type of business they can compete for by the expertise they have available, or by the market's perception of that expertise, and by the size of contract that they can service.

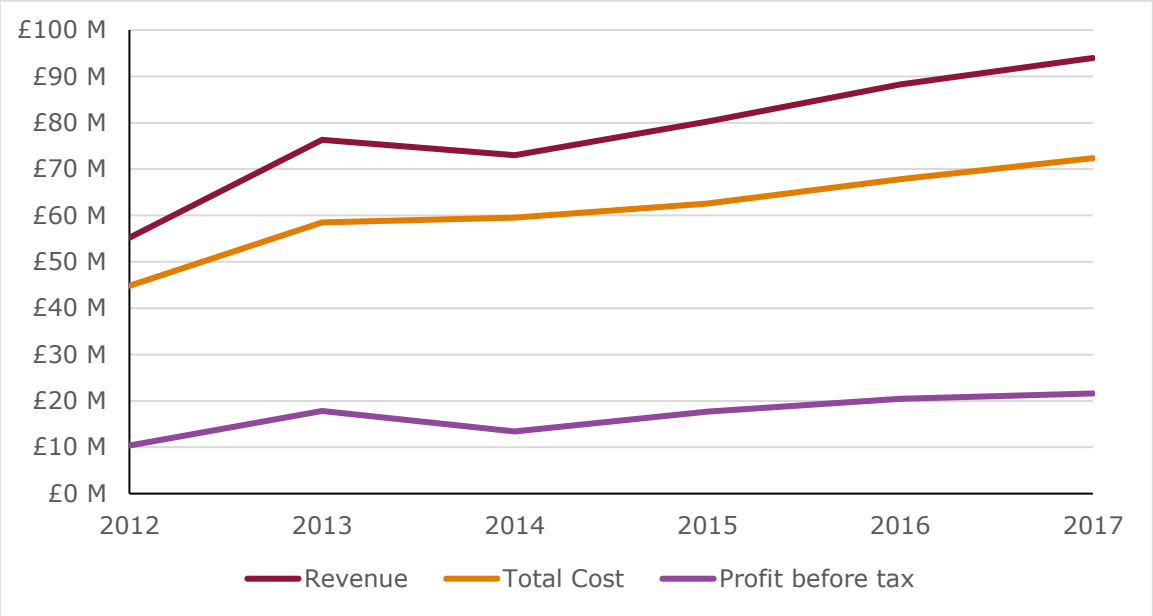
32. We see these incentives reflected in firms' short and long-term business plans. All firms highlight the need to maintain service quality. A number of respondents target organic growth by utilising their current expertise in other geographic markets. However, for firms seeking to expand in the short run, a large number cite the need to expand their firm's expertise by hiring the right staff. Further, if firms need to reach a certain scale to be able to compete for the next tier of business it would explain the reason a number of firms cite their intention to acquire expertise not through strategic hires but through mergers. Due to its evident importance we present the results of our analysis of scale and financial performance in detail below.

Market profitability

33. We have defined revenue to be income earned from the placement of risk into the London Wholesale market, regardless of whether the broker is dealing with another broker or the end client. Revenue includes earnings from placement and non-placement services including risk consulting and data analytics. We have included revenue that was related to or enabled by the firm's wholesale broking business, including any investment or interest income. Profit is defined as all revenue less all costs excluding tax.

34. Figure 3 shows that average revenue and cost has risen over the period of our sample. There are number of trends underlying these movements. The sharp increase between 2012-2013 is a function of our data set, however. One of the larger brokers was unable to supply in-scope data for this period and it is affecting average financials.

Figure 3: Average revenue, cost and profit 2012-2017

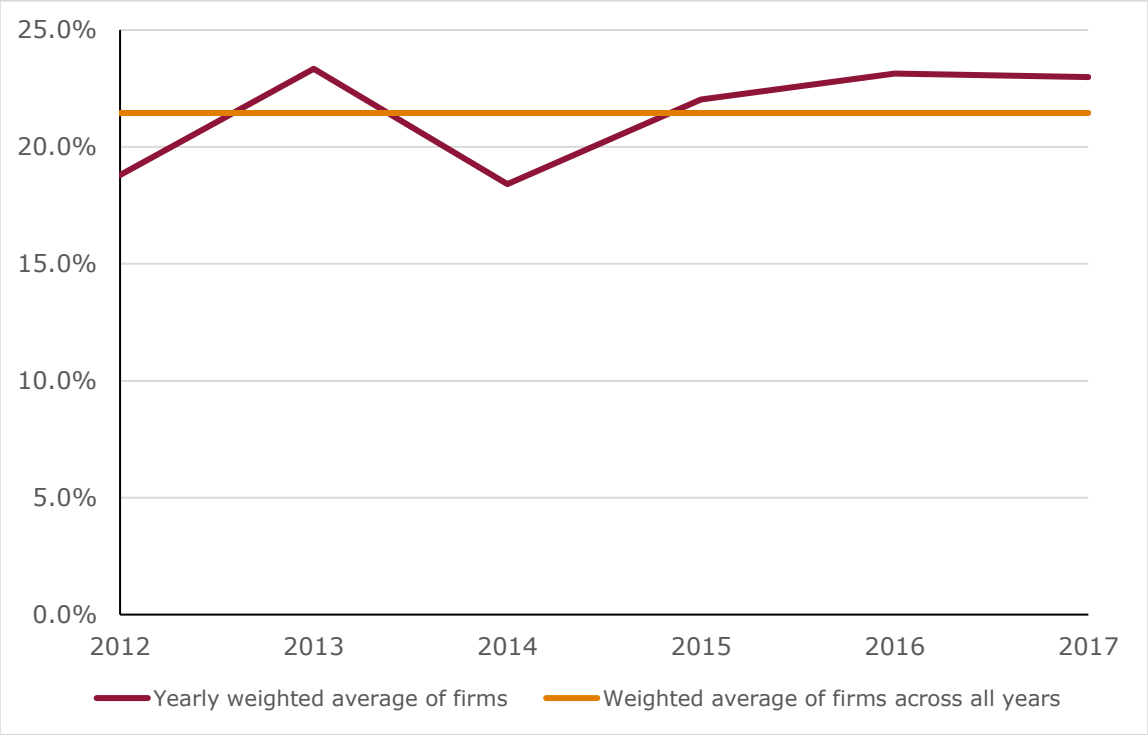


35. The remaining upward trend of both revenue and costs is, in part, attributable to a shift in exchange rates. A number of larger brokers report in USD which we have converted to GBP. The weakening USD:GBP exchange rate over the period of our sample has tended to add a slight upward trend to the data.

36. In addition, different firms experience different trends over the period. Some firms have grown substantially in several cases close to doubling their size, driven by a combination of mergers and organic growth. Other firms in our sample have held steady or seen a slow decline in their financials. As shown in Figure 3 above, GWP, revenue and cost typically moves together and on average profitability growth follows a similar pattern.

37. Figure 4 below shows the average profit margin across our sample for each period. Generally, this follows a similar pattern to absolute revenue, cost and profit movements. In the most recent period, however, cost climbs at a similar rate to revenue. With minimal growth in absolute profits, margin falls in the last period of our sample.

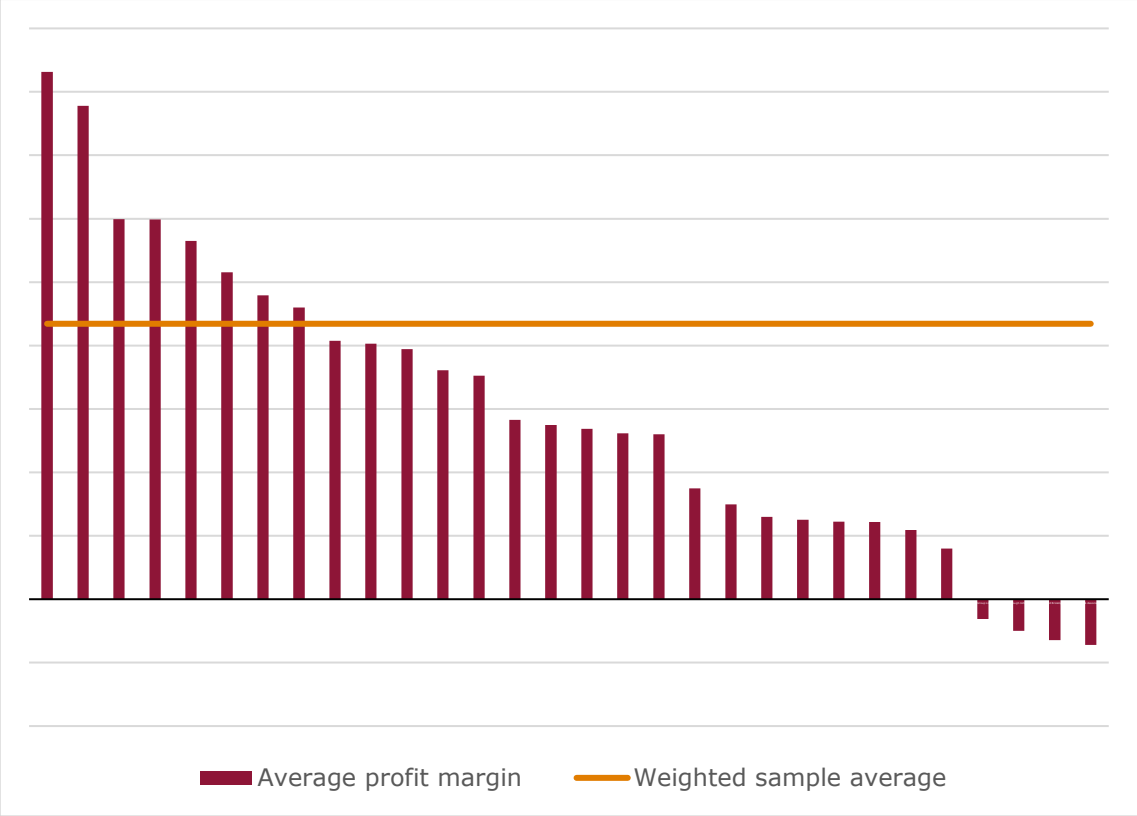
Figure 4: Weighted average profit margin, 2012-2017



38. Average operating margin across our sample is 18-23% between 2012 and 2017. This gives an average profitability of 22%, with a variance of around 0.5% for about two-thirds of the firms in our sample. For the remaining firms, margins are much more variable, with higher average variance typically driven by one or more years in which the firm was loss making. Despite a growing market an arithmetic average of averages does not produce a materially different figure for the sample over all.

39. Whilst the data suggest a material level of profitability overall, an examination of the distribution of profitability is critical to our assessment of competitive pressure. Figure 5 below shows the average profit margin for each firm in our sample.

Figure 5: Weighted average profit margin 2012-2017 for each firm in our sample



40. We find that due to weighting close to three quarters of our sample are below our samples' average profit margin. Nine firms in our sample reported at least 1 loss-making period with 4 of these firms being loss-making overall between 2012-2017.

41. Our market share analysis suggests that the broker market is moderately concentrated overall. Firms' financial performance across our sample seems characteristic of such a market. Economic theory would suggest in these circumstances that some firms would be earning high levels of return and some firms' normal returns, i.e. zero surplus. A conclusion of excessive returns would typically need to be drawn for a market as a whole in which all firms make high and sustained profits. These data do not support a conclusion of excessive profitability.

Return on equity

42. Typically, we conduct further analysis of profitability looking at return on investment. This can help identify a low margin firm that is in fact making excessive returns on a very small amount of economic capital.

43. In this case 'loss-making firms' means the return on investment for a sizeable section of our sample would be negative and hence below any benchmark of competitive return. However, we have found an analysis of firms' equity challenging for a number of reasons.

44. Gathering usable data on firms' capital has proven difficult. Many of the firms in our sample found it difficult to provide an estimate of their capital position that

corresponded to our scope. The broking business model does not allow for a split of capital that has an obvious economic interpretation, making allocation difficult. In some cases, especially for subsidiaries of larger groups, this meant no data could be provided even at the whole firm level of our request. For the same reason, only 1 firm provided an estimate of capital data in their segmented data submission.

45. Our sample suggests an average accounting rate of return on equity of around 21%, but this is not a measure of the return on economic capital. For firms that rely on physical assets, regulatory capital, technology, a network of branches, accounting data is typically a useful proxy for the economic capital. However, the high level of staff cost, and the focus on staff in the firms' business models, suggests that human capital is central to the generation of revenue in the industry.

46. In the FCA's analysis of the asset management market,[2] for an industry with a similar human capital-centric business model, we multiplied the accounting measure of capital by 2.6 times to derive a measure of economic capital. If applied here, our analysis would see returns sitting within the range of normal profitability suggested by the capital asset pricing model and firms' own submissions on their cost of equity.

47. Due to these difficulties, and the low probability that the results of a more detailed analysis would alter our view of competitive pressure within the market, we have not focused on return on investment as much as in a typical investigation.

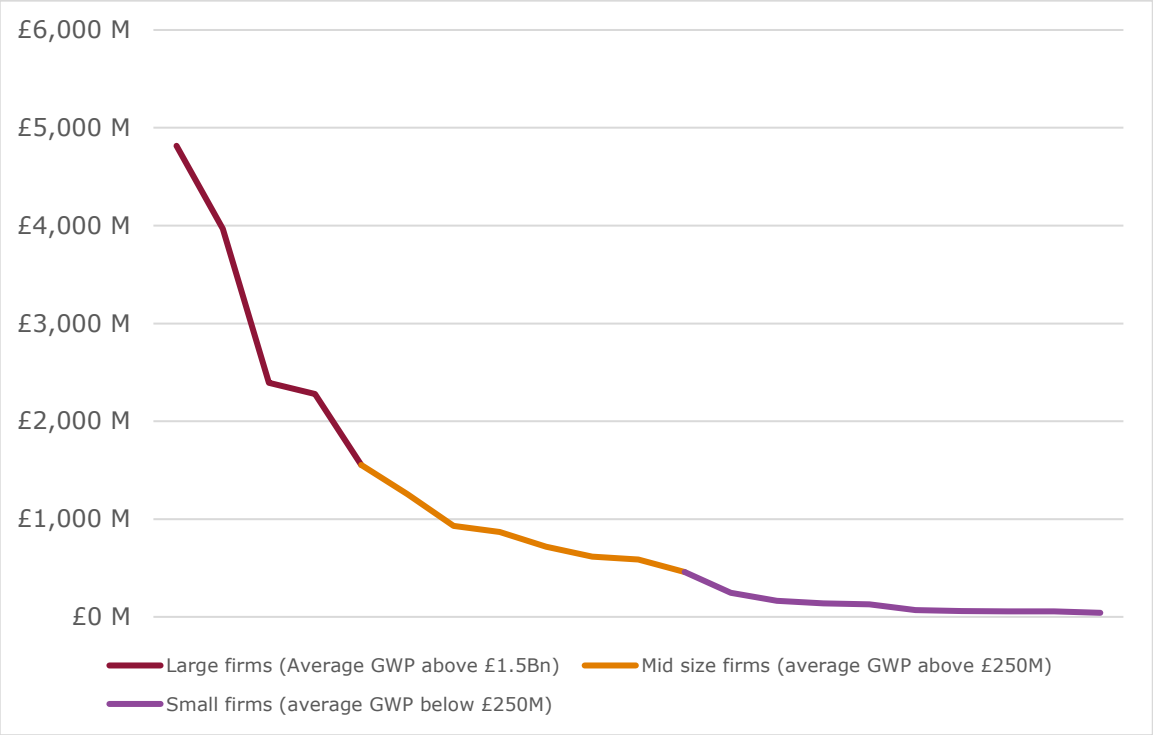
Profitability by size

48. Our profitability analysis, whilst not supportive of excessive profitability in the market, does indicate that scale may be an indicator of profitability. If we had reason to believe that larger firms operated in a separate market then we would need to look at their profits to determine if they were making an excessive return.

49. Our analysis groups firms by their average gross written premium between 2012 and 2016. The spread of our sample is shown in figure 6 below.

[2] https://www.fca.org.uk/publication/market-studies/ms15-2-2-annex-8.pdf

Figure 6: Grouping by size of average gross written premium



50. We have grouped small niche firms together defining them as being those brokers with placing an average GWP of below £250m per year.

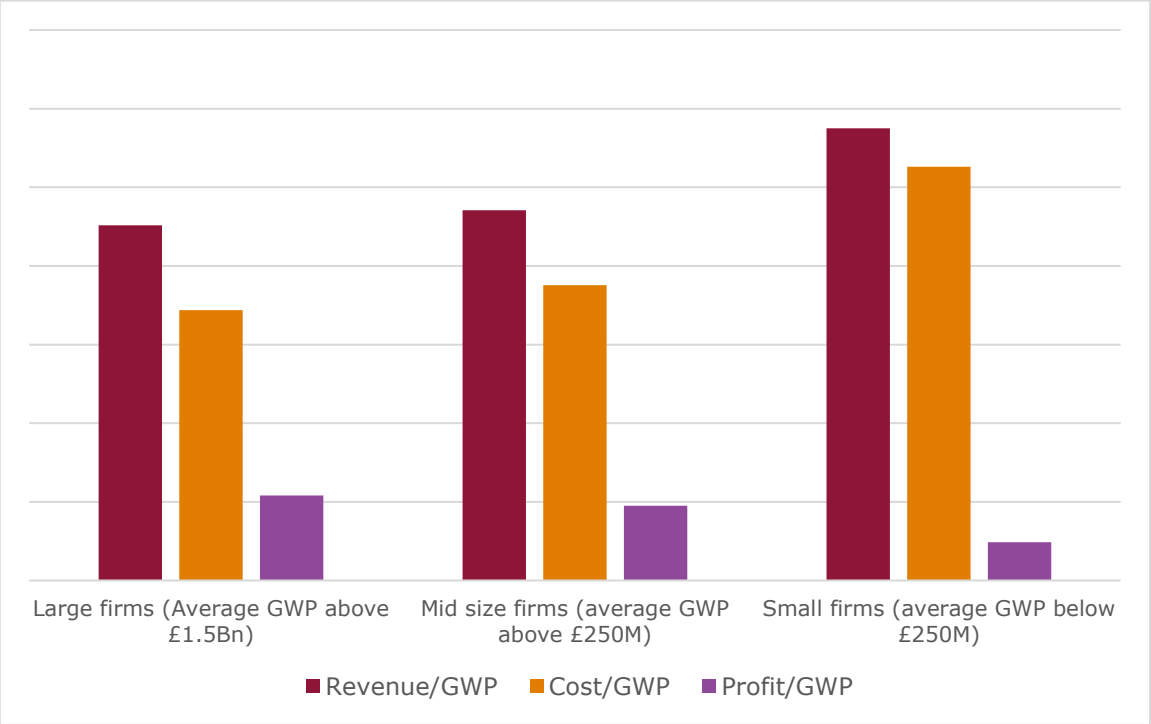
51. Our next group represents a mid-size mass market, rather than firms offering niche propositions. This is notable inflection point in the data. If we order firms by average GWP the largest 'small' broker places around half the GWP of the smallest 'mid-sized' broker.

52. Finally, the largest firms in our sample are those we identify by both the size of their GWP, above £1.5bn, but also by a qualitative judgment based on their business model, the extent of their wider infrastructure and their ability to compete for the business of the largest clients.

53. To test the sensitivity of these results, we tried several formulations of these groups. We found that, whilst no linear relationship existed in the dummy data, variables introduced to produce a tiered regression was statistically significant. The 3 groups used in the main line of our analysis produced the most significant results; however, other formations produced similar results.

54. Having grouped these firms together, we looked at their profit margin and also the revenue, cost and profit per pound of GWP placed in order to analyse profitability whilst controlling for scale. Figure 7 below shows the results of this analysis.

Figure 7: Revenue, cost and profit per pound of GWP placed (2012-2016)



55. Our analysis shows that, for the small providers, revenue per GWP is the highest of the 3 groups. We also find that cost per pound GWP placed is higher, with the result that the smallest firms make the lowest level of profit per pound of GWP placed, commensurate with a profit before tax margin of around 8%.

56. This seems consistent with our analysis of smaller firms' business models, who tend to offer more specialist, niche offerings based on their expertise and their ability to offer bespoke personalised service to clients. This bespoke service comes at a higher cost per pound GWP.

57. Mid and large-scale firms generate lower revenue per pound of GWP than small firms. The difference in pound per GWP is not large but the proportional fall in cost per pound of GWP translates into a material difference in margins. Mid-sized firms earn margins around 20% and large firms' margins around 24%. This suggests that differences in profitability are driven not by higher prices, as we would expect if firms were exercising market power, but by economies of scale.

58. Our analysis suggests non-placement revenue is proportionally higher for large firms over mid-sized and smaller firms. Estimates of revenue per pound GWP for large firms with data services stripped out would widen the gap between large and midsized firms. This would strengthen our conclusion that margin differences are driven primarily by economies of scale with larger firms earning the lowest revenue per pound of GWP. This is inconsistent with a conclusion that the larger firms have market power within the risk placement market.

Profitability by risk class

59. Our analysis also looked at profitability segmented by asset type. We wanted to examine the effect higher concentration within a risk class had on broker profitability. We identified 2 risk classes, Aviation and Energy, as having notably higher levels of concentration.

60. We asked firms for a breakdown of revenue and cost along the lines used in their management accounts. As with other areas of profitability analysis, creating a consistent data set has been challenging. As discussed above some firms were unable to provide a segmental breakdown of their profitability even on a best endeavours basis, and so our sample size is significantly smaller at the segmented level. Firms differ in the way they sub-divide risk segments and can even vary over time as the firm reorganises itself.

61. The primary issue, however, is that some firms have fully allocated their costs, in some cases using revenue as a cost allocation method creating some circularity in the data. Other firms have not allocated all their costs but mixed front-line risk class departments, for example Marine or Aviation, along with central or finance departments.

62. In our analysis, we therefore sought to map comparable segments where possible. To overcome issues of cost allocation we have looked at gross profit (revenue less staff costs). As discussed staff costs make up the bulk of costs. A fairly high proportion of our sample allocated these costs directly. These costs also seemed to most likely to vary substantially between risk classes.

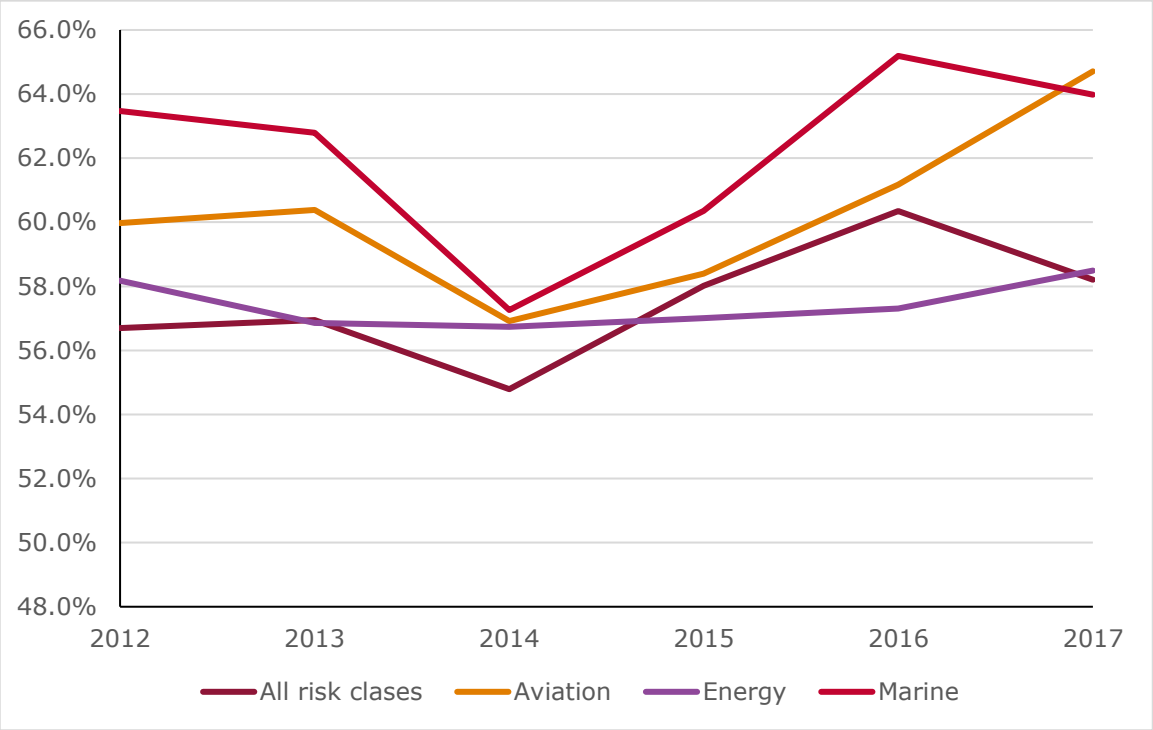
63. One part of our analysis looked at revenue/GWP, staff cost/GWP and gross profit/GWP. For the same sample as our pricing analysis, we attempted to match management accounting segments to the high-level risk group. This is necessarily imprecise, and the results of this analysis indicative at best; however, where firms have provided data on what risk types are included within their management accounting segments suggest a reasonable level of fit.

64. Aviation and Casualty Finpro seemed to attract higher rates of commission than other segments. We wanted to check whether this was commensurate with higher levels of profitability. We found that, across our sample, neither high level risk segment constantly outperformed average gross profit/GWP for every firm. We did find that Casualty Finpro generated the highest average across the sample as a whole but was a weaker performer for some firms. We found that Aviation did not have an average gross profit/GWP that was noticeably different from the sample average.

65. We therefore cannot conclude that higher commission rates are constantly leading to higher profit margins across our sample.

66. Our analysis also looked at weighted average gross profit cross all segments to establish a benchmark of profitability. Figure 8 below shows the gross profit of Aviation, Energy and Marine against this benchmark using weighted averages from across our sample.

Figure 8: Gross profitability of selected risk classes 2012-2017



67. Our data suggest that, whilst Aviation is higher than average in some periods, it is not that much higher than, for example, Marine which we identified as being relatively unconcentrated and is broadly represented across our sample. We also found that the Energy sector was not significantly different from the average of the sample as whole.

68. Our analysis remains an estimate, however. Of particular concern is the possible endogeneity of front-line costs that means areas generating greater revenue, either due to higher prices or larger contracts, will tend to attract the best talent and for these staff to be paid more. This would create a correlation between revenue and cost that could obscure the effects of increased concentration.

69. Though our results are only an estimate we have not found a strong correlation between risk class, concentration and profitability. It is worth noting however, that aviation and energy segments for small brokers only seem to be a small proportion of their business compared to large brokers. Where we have data on large brokers' Energy and Aviation business, these divisions make up a significant proportion of the bottom line in absolute terms even though their margins are not notably higher than other divisions of the business.

70. In this respect, there may be some correlation between the type of risk placed and profitability since it may be a further reflection of the different market that larger brokers are servicing.

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