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Insurance intermediaries: financial resilience and acquisition resistance in 2021

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Wider and accelerated consolidation among insurance intermediary firms (eg authorised insurance brokers. and managing general or other underwriting agents, and their appointed representatives) seems highly likely this year and next. This is indicated by the FCA's 'Covid-19 financial resilience' findings from a survey of 23,000 financial services ("FS") firms, of which 3,370 respondents were authorised insurance intermediaries. Covid-19 is also associated with, and possibly exacerbates, an insurance market which seems structurally likely to harden further.

Financial resilience surveys

Last month, the FCA released the results of its surveys, showing the position as at February 2020 (pre-lockdown) and May/June 2020.

The FCA said that its objective *"isn't to prevent firms failing … But … to ensure this happens in an orderly way … we can intervene faster so that risks are managed and consumers are adequately protected."*

Intervention could include steps as to client assets and firms' capital or liquidity reserves, or the management of business 'wind downs'.

The surveys covered a range of FS intermediary firms, including in the insurance, retail and capital markets. The surveys did not include banks, building societies, credit unions, life insurers and general insurers, which are regulated for financial stability by the Prudential Regulation Authority.

The FCA has now launched a third survey of firms' financial resilience and suggested this will become a regular form of financial reporting.

Key trends for insurance intermediaries

The overall picture for insurance intermediaries tends, on balance across all of the FCA's metrics, towards the negative. While some firms have benefited in the short-term from counter-cyclical business, with median profitability appearing to increase during the first lockdown, the sector does expect overall income to decrease (albeit less so than other sectors within financial services), and seems notably reliant on government support.

Compared with the FS industry as a whole, the headline points for the insurance intermediary are that it has:

- the most reduced access to liquidity (eg cash, overdrafts and liquid assets), and
- the second highest rates of use of government support, but
- notably higher increases in profitability, which suggests costs are being managed effectively.

Key indicators of the insurance intermediary sector's resilience can be identified from the FCA's findings as follows:

- Insurance intermediaries' access to liquidity on an unrestricted or unconditional basis reduced by 30% during the first lockdown of 2020, from £16.2 billion to £11.4 billion. However, the sector was not uniformly affected:

    - Within the metric of ‘access to liquidity’, the median insurance intermediary has gained by 27.3% (with liquidity rising from £107,812 to £137,268).
    - It appears that reductions in access to liquidity are greater for larger firms; of course, larger firms are more likely to have had greater access to liquidity immediately prior to the pandemic, and it is possible that smaller firms’ access to liquidity is a result of their access to government support (eg government loans are being held as cash, and possibly leveraged for additional borrowing).
- Insurance intermediaries have an average expected 3-month cash surplus of 3.5% (i.e. the ratio of income and retentions over outgoings); this is the lowest in the FS industry, and the other FS sectors have 10% to 25% expected 3-month cash surpluses.
- 14.0% of insurance intermediaries have negotiated debt repayment extensions; the FS average was 12.9%.
- 60.4% of insurance intermediaries have had, or are expecting to have, their income decrease; the FS average was 58.6%.
- In relation to expected decreases in income, insurance intermediaries’ outlook was pessimistic, but less so than for FS firms as a whole. Of the insurance intermediaries expecting to have their income decrease:
    - 1 in 4 expected decreases of 26% or more;
    - almost 1 in 10 expect decreases of 51% or more;
    - approximately 1 in 25 expects a decrease of 76% or more.
- While the FS industry has on average seen the overall number of profitable firms decrease by 2% during the first lockdown, the insurance intermediary sector has seen an increase of 2.3%. It should also be noted that the median insurance intermediary (by profitability) saw a 36.8% increase in profitability.
- 48.2% of insurance intermediaries report that Covid-19 has had a negative impact on their business model, with a further 48.4% reporting a neutral impact; the FS averages were 46.4% and 49.2% respectively.
- 43.8% of insurance intermediaries have furloughed permanent employees (second only to retail lending); the FS average was 37.1%.
- 19.0% of insurance intermediaries have made use of government backed loans (again, second only to retail lending); the FS average was 20.1%.

The FCA’s view is that as many as 4,000 firms across the FS industry have “low financial resilience and [are] at heightened risk of failure”, adding that these are “predominantly small- and medium-sized firms and approximately 30% have the potential to cause harm in failure”.

Implications amidst a hardening of the insurance market

Insurance industry commentators have for a number of years prior to 2019 observed that the market was largely ‘soft’. The watchword was ‘distribution is king’, meaning that intermediaries were in an advantageous position in negotiating remuneration agreements with insurers, including significant levels of commission, and forms of commission that gave the intermediaries a share of insurers’ profits (see e.g. the FCA's work on the London wholesale insurance market). Industry commentators also noted stories as to benefits in capital and asset provision from insurers to intermediaries, such as data and other contributions to IT systems, or 'soft loans'.

Prior to the pandemic, commentators noted the insurance market had started to swing back into hardening conditions. Headlines as to reductions in underwriting capacity – which necessarily contribute to ‘supply and demand’ for product distribution – included substantial changes in the Lloyd's market. Reductions in capacity have widened and deepened across the insurance industry, with key factors including persistently low interest rates and returns on investment capital, and a range of losses, both from the well-publicised acute effects of natural catastrophes, and more endemic problems noted by commentators in liability markets.

Covid-19 has created both a chronically adverse economic environment and an acute cause of loss to the insurance industry. The UK Supreme Court decision on the FCA’s Covid-19 business interruption (“BI”) ‘test case’ has led the Association of British Insurers’ to expect that Covid-19 related claims may cost the UK insurance industry in excess of £1.8 billion.

The Supreme Court decision presents an immediate issue for products with BI, since it over-ruled the ‘Orient Express Hotels’ judgment, a basis for much industry loss adjustment, which some have seen as tending to favour insurers.

The decision may have even more profound effects for intermediaries. It is possible to discern in its reasoning a rejection of an approach to policy drafting - and thereby marketing – frequently found in the insurance industry. The full extent of loss scenarios, and the ramifications for policy terms in this regard, were not always exhaustively tested, leaving matters open to later interpretation and dispute at the claims stage.

It seems likely that scenario analysis and policy terms will have to be more extensive, which may cause greater discernment and demands among customers, and more difficulty in selling unclear - or more clearly limited – cover. Such an environment favours intermediaries who are more adept at negotiating policy terms based on clients’ particular business attributes.

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