

Binding authorities - The Devil's chariot

Written by Julian Ward FCII

Delegated authorities are a major problem in the industry, but the pitfalls can be avoided and lessons can be learned from past mistakes.

Delegated authorities – and binding authorities in particular – are the biggest problem-generating machine in insurance and reinsurance today, costing the industry billions of dollars. Delegated authority vehicles generate approximately a quarter of the business in the London Market, we estimate and of that around ten percent ends in tears. Let me begin by setting the scene with a very familiar real life case study:

“Singularly dishonest” and “ruthless” were two of the phrases used by the judge to describe broker Stirling Cooke Brown (SCB) in the well-publicised high court case involving Sphere Drake versus their underwriting agent, Euro International Underwriting Limited (EIU).

The background surrounded the “WC carve-out” market of the late 1990s whereby the personal accident element of workers’ compensation business was to be carved out and separately reinsured. Sphere Drake granted a binding authority to EIU only after the latter had already committed to SCB to use the facility to write WC carve out, one of the court’s findings. Premiums of \$25 million generated losses in excess of \$250 million and rising.

While the integrity of the underwriter at Sphere Drake was left intact, his reputation was not; in particular that his supervisory duties in relation to the binding authority had: “fallen well below that which was to be expected of any competent underwriter; if he had not acted with gross negligence and dereliction of duty [which Sphere Drake’s internal controls failed to prevent], the dishonesty of EIU and SCB would have been investigated long before it was,” said Mr Justice Thomas.

Reality is scarier than perception

Certainly this case illustrates the devastation that can be inflicted by a fraudulent binding authority and records the fact that this could have been avoided and/or mitigated if carefully policed procedures and regular audits had been standard at Sphere Drake. The reality is that within the London Market, millions more are wasted by the failure to monitor and control “routine” binding authorities, most of which are entered into with honesty and best intentions.

The industry has forgotten the lessons of the past – seeing delegated authority as an easy route to premium income and failing to implement the procedures and checks that should be in place right from the start. When these measures are in place and problems happen, then they can be dealt with at the “issue” stage.

When due diligence has not been observed and things go wrong, matters easily spiral out of control leaving large, messy and expensive problems to deal with. There

would be far fewer problems with delegated authority if it were applied to appropriate classes of business, carefully monitored and policed and more regularly audited.

Playing by the rules

So what say the regulators? Both the Financial Services Authority (FSA) and Lloyd's regulatory division have launched much-publicised initiatives to increase the pressure on the industry to address the problem. There is a consensus that in overview terms, the FSA is trying to raise the bar for the insurance industry to the level of the regulations now in place in the banking world. The far-reaching Consultation on Delegated Underwriting at Lloyd's reflected efforts to improve the practices and procedures of that marketplace. While both of these regulatory initiatives are to be applauded and welcomed, there is a danger that the market will view these as no more than tick-box requirements.

Red flags – applying lessons from the past

But what can we learn from past pitfalls? What are the red flags we should look out for? The ways in which a binding authority can go wrong are extremely varied and every audit "review" to identify these should be tailored to the circumstances and always have a watching brief for the unexpected.

All diligent underwriters who delegate authorities and auditors who perform reviews on their behalf, should be aware of the more standard checklists and red flags in conducting an audit. One of the appendices to the Lloyd's consultation document neatly sets these out. Among the less common red flags I look out for, which all too frequently are missed from such checklists, are the following:

Restructured contractual arrangements

Restructuring of programmes and authorities from one underwriting year to the next may be completely innocent. It may also be a shield to providing true and revealing historical information and statistics!

Sub-delegation of authority by the coverholder

If this was not authorised, clearly this is a potential concern, but even if it has been, the potential for miscommunication and misapplication has increased multiple-fold.

Reinsurances of binders

Countless times I have conducted audits of individual treaties which themselves have reinsured – inherited - a range of underlying binding authority facilities. Here you have the worst of both worlds!

Vague conditions

I remember one binder constructed to accept small lines of CAR business on a quota share binder included the condition "first loss business may be bound". All 200-plus cessions bound were on a first loss, not quota share or excess, basis.

Untimely or vague reporting, unavailable documentation

The correlation between delayed, incomplete accounting and / or incomplete documentation on the one hand and poor-performing business (from an underwriting perspective) on the other is absolutely indisputable. Until proven otherwise, make it

an assumption.

Expired authorities

Clearly once an authority has been cancelled or otherwise been withdrawn, the coverholder has little incentive to apply best business practices and if holding concurrent facilities, might “select against” the expired facility in favour of a new or ongoing one.

Emphasis on relationships

This is my favourite “missed flag.” All too often underwriters undertaking pre-underwriting “reviews” are shown around and then wined and dined without the opportunity for in-depth audit analysis. Beware separate marketing trips from audit inspections.

Protecting the bottom line

While acknowledging all of the above, too many companies and syndicates consider that it is too expensive to adopt a prudent policy of regularly auditing coverholders. I believe this to be a false economy.

Let us assume an underwriter grants 20 coverholder authorities and that there is a five percent chance that any one of these might go “badly wrong” to the tune of a \$1 million underwriting loss. Assuming that a comprehensive internal and external audit programme costing \$200,000 would identify and mitigate or avoid 50 percent of these “bad apples”, what would be the underwriter’s prudent course? Basic mathematics and probability theory (surely among the skills of most prudent underwriters?) suggest that regular monitoring and auditing will - in the long run - be a significantly cheaper option.

It is indeed an irony that insurance, the very industry sector that deals in fully understanding risks, often takes more blind risks than is reasonable fair and decent to its shareholders. In true financial terms, due diligence is the inexpensive way of protecting the bottom line.

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