

Shedding the Light on Insurance Brokers' Remuneration: the Role of the Fees

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Abstract

The academic literature analyzed the way insurance brokers are compensated and different theoretical models, discussing the tradeoff between commissions and fees-based compensation system, have been developed. However, an ethical lens through which those systems are applied is still lacking in extant literature. To close this gap, in this manuscript we concentrate on fees and propose to the fore some practical examples brokers and customers may face. These examples, set in the Spanish market (which allows both commissions and fees), are used to discuss the role of fees in contexts where unethical behaviors may occur.

Keywords: Commissions, fees, insurance broker remuneration, spanish case study, opportunistic behaviors.

La remuneración de los bróker de seguros: aclaraciones sobre los honorarios

Resumen

En este trabajo, se estudia la forma en que los bróker son retribuidos: por un lado, a través de las comisiones y, por otro lado, mediante los

honorarios. En concreto, se revisa la literatura académica que presenta diferentes modelos teóricos entorno al sistema de compensación de los bróker por la prestación de los servicios a sus clientes. Así, se realiza un análisis de casos del mercado español de seguros, con el fin de determinar si el sistema de la retribución a través de honorarios da lugar a un comportamiento no ético dentro de la actividad profesional del bróker de seguros.

Palabras clave: Comisiones, honorarios, remuneración bróker de seguros, estudio caso español, comportamiento oportunista.

1. INTRODUCTION

In the last 10 years, the European insurance market faced several changes due to the new European Directives^{1, 2}, the financial crisis (Berry-Stolzle *et al.*, 2014) and the introduction of new technologies (Babu and Kumar, 2014). In this environment, the market share of distribution channels is also changing; let's think for instance at the *Bancassurance* which has started to dominate the life insurance market (Insurance Europe, 2014) at the expense of the agent channel or at the new technologies (ICT based) which have allowed remote pre-sales and sales activities changing the business itself.

The literature on distribution channels is vast and mostly focused on the two most adopted ways of distributing insurance policies –the *Agent* channel and the *Bancassurance*–respectively in the non-life and in the life insurance business. Surprisingly, the second most used distribution channel (Insurance Europe, 2014) –*Broker*– has not received, up to date, a big echo within the academic literature. In particular, the way insurance brokers are remunerated for their professional activity has been overlooked.

In this context we, thus, tackle this gap in the literature and shed the light on how insurance brokers get compensated; as highlighted in the literature review section of this paper, insurance broker' income has two main sources: (i) the commissions which are paid by the insurance companies to promote and sell their products; and (ii) the fees which are paid by the customers for the services provided.

In this research, we are mostly interested in fees since we argue that there is an overall opacity surrounding this compensation method; in particular, there are still some vivid doubts on when they are applied, how they are calculated and how fees and commissions compensate each other. According to this, the objective of this paper is to propose a constructive discussion of this topic from an ethical perspective which is lacking in the extant literature; to do so, we examine how conflict of interests may arise among customers, brokers and insurance companies and the role of commissions and fees in this framework of analysis.

In order to accomplish our goal, the Spanish Insurance business case is taken and discussed in the next paragraphs. Although this choice might be arguable because of the relatively small size of the Spanish insurance market compared to U.S. which is dominated by large insurance brokers (Cummins and Doherty, 2006), we believe Spain to be a good example for the following reasons: (i) insurance broker channel is largely diffused; (ii) the system allows both commission and fees; (iii) the market is highly regulated.

The reminder of this contribution develops as follow: section number 2 gives an overview of the European insurance market, its distribution channels with a particular attention to the Spanish context; section number 3 gives evidences on the European directive which regulates the role of the mediation by insurance broker and reviews the academic literature on brokers' remuneration (both commissions and fees); section four, instead, is the core part of the contributions in which our arguments are presented. Finally section number 5 concludes the paper.

2. THE EUROPEAN INSURANCE MARKET AND ITS DISTRIBUTION CHANNELS: A FOCUS THE SPANISH CONTEXT

2.1. Introduction

According to the last data published in 2014 by *Insurance Europe*³ (www.insuranceeurope.eu), the European Insurance Market (which consists of more than 5.300 firms) accounts for the 30% of the global insurance business registering, in 2012, a gross written premium of Euro 1.093 billion corresponding to a slight decrease year-on-year of 0.3% (Insurance Europe, 2014).

Although most of the financial markets were visibly performing better, the difficult macroeconomic conditions together with the low interest rates have not allowed the insurance business to reach the results achieved in 2010 (the best year after the beginning of the financial and economic crisis) (Insurance Europe, 2014). If, on one side, the non-life insurance market (motor, health and property) registered an increase of 1.1% compared to 2011 (confirming that even in periods of economic uncertainty people do buy insurance to protect things they matter), on the other side, the life insurance business (which is about the 60% of the whole market), registered a slight decrease since short term priorities, such as day-to-day expenses and loan repayments, took precedence on long-term investments (Insurance Europe, 2014).

The insurance business is characterized by different distribution methods (Kim *et al.*, 1996) and (Regan and Tennyson, 2000) whose composition changes country by country. Following the classification provided by the Insurance Europe, insurance products can be distributed in three different ways: (i) *Direct Writing* (through insurance employees and distance selling such as internet and mailing); (ii) *Intermediaries* (through *Agents* both tied and multi-tied and *Brokers*) and, finally, (iii) *Bancassurance*.

To avoid duplication with other contributions that already discussed the different distribution channels of insurance markets, we will take a deep look on the *Intermediaries* and, in particular, on *Brokers*.

Historically, the predominant distribution channel for larger insurance companies in the individual market is the *Tied Agent*^A (CeTIF, 2013; Dumm and Hoyt, 2003) channel which consists of financial intermediaries acting as agents selling insurance products under the exclusive agreement with a specific company (more formally we may call it Investment Service Provider, ISP) whose working activity is under the full and unconditional responsibility of the insurance company.

The insurance market distribution is also characterized by the presence of independent agents or, better said, *Multi-Tied Agents* with a non-exclusive sale relationship/ contractual agreement which allow them to distribute products of more insurance companies (Lochi *et al.*, 2009).

Finally, insurance products are also distributed by insurance *Brokers* which are individuals or businesses selling insurance products of

different companies with no formal relationship with the insurance firms. However, *Brokers* differ from the agents since agents represent one (tied agent) or more companies (multi-tied agent) and, thus, work for the interests of the insurance company, while insurance brokers represent the insurance purchasers and work to satisfy their interests and needs.

In accordance to the evidences proposed above, in the next paragraph the most recent data at European level are given with a particular focus on the Spanish market.

2.2. Insights on the European Distribution Channels: Evidences on the Spanish Market

Insurance products are distributed differently depending on the regulatory environment and on the technological developments of the country where the business takes place (European Insurance, 2014). However, although data and market share are different country by country, some mayor evidences emerge at European level both for the life and non-life business (Table 1).

Table 1. Data at 2012: Life and Non-Life Business

Life Business			Non-Life Business		
Channel	Spain	Italy	Channel	Spain	Italy
Bancassurance	70%	49%	Bancassurance	13%	3%
Agents	16%	16%	Agents	39%	81%
Brokers	5%	1%	Brokers	20%	8%
Other	9%	34%	Other	18%	8%

Source: own development.

Firstly and with respect to the life insurance business, the *Bancassurance* is (and continues to be) the main European distribution channels (Shneider, 2014; European Insurance, 2014) due to the high penetration ratio of bank branches and to the “one-stop-shop” effect of purchasing different products (such as credit cards, loans, insurances) in the same shop (the bank branch).

It is interesting to notice that although this channel is largely used in Europe, in a developing country such as India “Bancassurance is relatively a new term” (Agrawal *et al.*, 2014). If we take the data published in

the report aforementioned, in Portugal and France, for example, more than 60% of the life premiums are distributed by the *Bancassurance*' channel. Within this type of business, insurance broker are generally the second largest; in the United Kingdom, for example, brokers are even the predominant ones with a market share close to 75% as well as in Germany with a 50%.

If we turn now to the non-life insurance market, the *Agent* channel, instead, continues to be the first and dominant distributing channel followed by *Brokers*, *Direct Writing* and *Bancassurance*. However, as anticipated above, that is not true in all the cases; again in UK and Belgium, for example, brokers have a significant market share higher than 50%.

Given this introductory data, this study focuses on the Spanish insurance market with a particular attention to the insurance distribution channels both for life and non-life insurance premiums.

According to this, we took a look at the reports published by the *Dirección General de Seguros y Fondo de Pensiones* (the national Authority supervising the insurance market) and found out the direct and indirect premium, from domestic and foreign business, amounted, in 2012, to Euro 57.7 billion decreasing by 5.47% respect to the previous year (DGSFP, 2012). The Spanish market which, in terms of volume, is composed almost equally by life-premium and non-life premium (the volume is about Euro 30 billion each) suffered a decline because of the sharp decrease of the life-premium market (-10.54%) while the non-life market contracted by only -0.62%.

Let's now turn to the distribution channels that characterize the Spanish market both for the life and non-life.

With respect to the former, we can observe that, also in Spain, the *Bancassurance* is the leading channel with 70% of the total market share. Regarding the classification proposed by Insurance Europe, the *Intermediaries* have the following market share: 15.7% the *Agents* while 4.80% of the volume is distributed through the insurance *Brokers*.

If we turn now to the non-life premium, the *Agents* (in line with the data at European level) are the predominant channel through which insurance policies are distributed (39%). Insurance brokers immediately follows them with a 20% of the volume while Direct Sales is the third channel (18%) followed by *Bancassurance* (13%).

In terms of year per year variation, we can notice for the *Intermediaries* that, in the life business from 2011 to 2012 the *Agent* channel decreased its market share by 2% in favor of the *Bancassurance* that increased its share by 2% (from 67% to 69%) and that also *Brokers* faced a decrease of approximately 2.15%. The same trend can be observed in the non-life market where both the agents and the brokers faced a decrease of 2% each from 2011 and 2012.

It now becomes interesting to benchmark the Spanish insurance business with other countries which may be similar both in terms of size and culture (Hettinger, 2008). To do this, the Italian case study taken.

The Italian insurance market, in terms of direct and indirect premium from domestic and foreign business, amounted, in 2012, to Euro 108 billion declining by 4.6% as a result of a decline of life insurance premium of 5.5% and of 1.9% in the non-life sector (ANIA, 2013). According to the analysis conducted by the National Association for Italian Insurances (ANIA), the drop of the gross written premiums, which were in 2012 equal to Euro 69.7 billion, was due to the decline of the nominal disposable income (by 2.2%), to the diminishing propensity to save and to a larger flow of investments which went to time deposit, banks instruments and postal securities (ANIA, 2013).

On the other side, the non-life income premium amounted to Euro 35.4 Billion for the 92 Italian and 2 non-EU insurance companies operating in non-life classes. The decrease by 1.9% in nominal terms was the result of a 2.2% decrease in the motor insurance business which accounts for 57% of the overall non-life income.

In terms of distribution it is now important to distinguish again from life and non-life premiums. With respect to the former, in the Italian business market, the main distributing channel remains, for 2012, the *Bank Branches* (including also post office branches) with a 48.5% of market share, followed by the *Financial Salesmen* (23.3%), the *Agent Channel* (16.3%), *Direct Sales* (10.7%) and, finally, *Brokers* (1.1%). With respect to the previous year, *Bank Branches* suffered a decrease by 16% while the *Agents* reduced their gross written premium by 5.9%. However, *Financial Salesman*, *Direct Sales* and *Brokers* increased their share by, respectively, 19.8%, 6.6% and 16.4% (ANIA, 2013).

If we turn to the non-life premiums, the composition of the market share changes significantly; *Agents* keep on begin the predominant

channel in the Italian market with a market share equal to 81%, followed by *Direct Sales* (8.1%), *Brokers* (7.6%) and *Bancassurance* (3.2%). However, we have deliberately classified *Brokers* as the second main distributing channel following the results of a study promoted by ANIA and AIBA (the Italian Association for insurance Brokers) which claims that figures on *Brokers* are underestimated since it is argued that a significant income generated by them is presented to the insurance companies via the *Agent channel*. Taking this into account, it has been estimated that the overall non-life premium generated by the *Brokers* are equal to Euro 10.9 Billion which is roughly the 31% of market share.

According to the data presented above and collected by different sources (Europe Insurance 2014; ANIA, 2013; DGSFP; 2012, 2013) some capitulatory considerations can be done. Firstly, and in line with data at European level, both in Italy and Spain *Bancassurance* and *Agents* are the dominant distributing channel respectively for life and non-life insurance business; data presented above show how this dominant position is far to be attacked by other channels (let's think at the 81% share of agents in the Italian non-life market or at the 70% market share in the Spanish life-market by *Bancassurance*).

Secondly, it is interesting also to note how, in the non-life business, the ranking of distribution channels is equal for Italy, Spain, and, generally speaking, at European level where Intermediation is the most adopted channel (agents and brokers are the first and two channels). Thirdly, we have not found a 1-1 correspondence among data at European level and data at Italian and Spanish level for the life-insurance. In particular, although in Europe Brokers represent the second channel after *Bancassurance*, in the analyzed countries insurance brokers have the lowest market share (1% in Italy and 4.8% in Spain).

3. INSURANCE BROKER'S REMUNERATION

3.1. The Role of Insurance Broker and its Legal Framework in the Spanish Market

As briefly described above, insurance broker is a professional role whose task is to mediate between insurance companies and customers by matching trading partners (Hoffman *et al.*, 2011). Broker's powerful role is largely discussed within the academic literature since many years. For

example Regan and Tennyson (1996) and Regan (1997) claims that independent intermediaries are better than exclusive agents at serving consumer and assessing risks in uncertain markets. Schiller (2009) argues that the key role of brokers is to prevent adverse selection while according to Karaka-Mandic *et al.* (2013) brokers play a fundamental role in reducing search costs.

Generally speaking, broker's primary role is to provide insurance coverage on behalf of their clients. Brokers may be engaged, among other activities, also in consulting, wholesale or reinsurance activities, alternative risk financing, risk analysis and human resource consulting activities (Ragin *et al.*, 2014). Broker's role can be articulated in the following way: (i) customers acquisition and analysis of their needs; (ii) market analysis; (iii) risk evaluation and identification of the insurance companies which may fulfill the requirements and the needs of the customers; (iv) contract definition and contract management; (v) support in the settlement of "damages".

Before focusing on their remuneration, it is necessary to frame the normative which regulates the insurance Spanish market.

The role and the activities of insurance brokers are regulated by the law 26/2006 on insurance and reinsurance mediation and it is supervised by the DGSFP which institutes every year an exam for those persons willing to operate as brokers; in order to operate in the Spanish market, brokers have to give proof of their competences, underwrite an insurance policy in case of mistakes causing damages, demonstrate a certain economic capacity to practice their profession and, finally, have to present a business plan to be approved by the DGS (BOE, 26/2006)⁵.

Similarly to the Spanish case, in Italy any broker must be registered in a Mediator's register which allows them to operate within the national territory; to be enrolled in this register, Italian law imposes the following rules: (i) brokers must not have any criminal sentence/ ever being involved in any bankruptcy procedure, (ii) they must possess specific and deep knowledge; (iii) they must not have any bound with insurance companies and have to prove to have a diversified portfolio of customers; finally, (iv) they must have an insurance policy for potential mistakes. These principles are generally defined as: honorability, professionalism, autonomy and guarantee.

3.2. Broker's Remuneration: A Literature Overview

This paper aims to analyze a question that is highly relevant, both from a theoretical and a practical perspective: how insurance brokers are paid. Brokers remuneration systems are usually based either on commissions on their products, or alternatively on fees-for-advice. Thus, the academic literature on insurance brokers' remuneration is scarce. However, apart from the general literature on the related topics of adverse selection/moral hazard problem involved, there are many papers dating back from late 1990s, which are specially devoted to analyze questions highly related this work. The authors are, among others Posey and Yavas (1995) and Posey and Tennyson (1998), offer search models in which insurers and consumers, to achieve an appropriate balance between price and risk. Seog (1999) examines insurance market in which consumers are poorly informed about the price distribution and (Hofmann and Nell, 2011) explain in their paper because brokers tend to be compensated by insurers.

Posey and Yavas (1995) modeled the insurance market in terms of two-sided search, with consumers searching to find an appropriate insurance policy and firms searching to find customers with appropriate risk characteristics for their products (Posey and Tennyson, 1995: 96-97). Also these authors present that insurance products are not strictly homogenous, and hence price may be only one of many factors in consumers' purchase decisions. Therefore, the characteristics of insurance price distributions are consistent with the existence of costly price search (Posey and Tennyson, 1998:110).

In the same line of investigation, Hofmann and Nell (2011) offer a rigorous approach to the question studied, it proposes a model based on a list of assumptions, it solves the model, and it reaches a series of results.

Thus, consumers gain information about product suitability by consulting and intermediary. Consumers may engage in costly search for products features or consult and intermediary. In this manner, current intermediary compensation systems are the fee-for-advice system, under which brokers are paid by consumer, and the commissions system, when the brokers are paid by insurance companies. They find that a fee-for-advice system leads to higher welfare than does a commission based compensation system. A commission sys-

tem implies that more consumers are informed by an intermediary than would be socially optimal (Hofmann and Nell, 2011: 289 and 303).

According to the above premises broker's income has two main sources: "direct commissions" and "fees" (Ragin *et al.*, 2014). With the first term we refer to a percentage of the premium of each policy managed by the brokers and paid by the insurance company which remunerates the broker for its mediating activity. According to (A.M. Best Company, 2012), the average commission rate paid, in 2011, by the U.S. insurance industry was 10.3%, which is roughly equal to Dollar 45.55 billion.

In addition to these premium-based commissions, brokers can receive "contingent commissions" which are ex-post payments by insurance companies related to performance criteria such as profitability, retention and growth requirements (Carson *et al.*, 2006) and (Focht *et al.*, 2013).

Moreover, brokers are remunerated by fees which can be split up in "flat fees" paid for placing coverage and consulting fees (Ragin *et al.*, 2014). Although commissions continue to drive broker's revenues (Mass, 2010 and Ragin *et al.*, 2014), fees are becoming more and more common; according to a series of interviews conducted by Maas (2010), broker's role is, in fact, shifting from the traditional "transitional role" (which is remunerated with direct commission), towards tailor made solutions with an emphasis on consulting services implying a remuneration based on fees.

If we take a look at the data published by A.J. Gallagher's (2012), the 52% of brokers' total revenues come from commissions, 16% from brokerage fees and 22% from the fees on the consulting activities.

By reviewing the not-so-deep literature on brokers' remuneration, we argue the majority of the contributions, most of which are theoretical and models-based, have somehow examined the trade-off between a compensation systems based on commissions or fees. Generally speaking this effort was done to understand how and which market welfare could be maximized and how its imperfections (deriving from a problem of symmetry of information) could be resolved.

In 1993 and 1994, Gravelle tackles this argument by theoretically comparing commissions and fee-for-advise based'

compensation systems for life-insurance brokers; in Gravele's model, entry in the broker market is endogenous and brokers face search costs. According to his contributions, under a pure fee regime only few consumers become informed and consequently, although a feed-based compensation may lead to a higher intermediation quality, once the number of brokers and consumers' purchases are taken into account, the pure fee compensation is not superior to the commission-based system (Focht *et al.*, 2013:4)

Some years later Shiller (2009), considered a duopoly market in which both (i) risk classification and (ii) matching mattered. Through his model, he pointed out that, the commission system is, under this setup, the best system because it provides incentives for an adequate risk classification.

A duopoly market and a context of uninformed costumers is the context designed in the theoretical model of Hoffman and Nell (2011), which compares fee-based and commission-based compensations; in their contribution, authors show that, when brokers behave not strategically, a commission-based system is inferior to a fee-based system because of the consumer transactions costs.

In response to the banning of commissions in European countries such as Finland and Denmark, Focht and colleagues reexamined fee-based and commission-based systems and showed that, in a situation of non-strategic brokers, both the systems are payoff equivalent (Focht *et al.*, 2013). In a context characterized by strategic behaviors, a fee for advice system with efficient side-contracting is again pay off equivalent to a commission system because in a commission system, companies explicitly compete on the commission rates and mismatches does not occur in equilibrium. According to the authors, regulatory actions banning commissions may be ineffective and may lead to mismatching incentives (Focht *et al.*, 2013).

In previous studies on the Spanish market (Latorre, 2015) some aspects of the production process within the insurance broker and the size of the insurance broker are presented, affecting performance in one way or another regarding debt collection. Other research (Latorre and Fariños, 2007) investigate whether there is a relationship between the ethical behaviour of insurance brokers and their operating performance. They

find that the better the performance and the larger the firm size, the worse the ethical behaviour.

In sum, up to date, the academic literature has mainly focused on the trade-off between commission based and fee based system to point out under which conditions one should be preferred to the other. However, none of the contribution took an ethical perspective to describe how and if remuneration may somehow mitigate a potential conflict of interest between customers and brokers. To close this gap in the extant literature, the next paragraph will take into account the Spanish example, where both commissions and fees are allowed, to discuss the role of the remuneration in the relationship between brokers' activity and customers need. In particular, we are going to provide two different examples and thus suggest some further reflections over this, up to date, underestimated topic.

4. THE POTENTIAL CONFLICTS OF INTEREST IN THE BROKER ACTIVITY AND THE ROLE OF FEES

By recalling Adam Smith's words in its *The Wealth of Nations* where men are defined as "self-interested" animals, Duska (2002), claims that when a financial professional has to sell two different products to the customer, he would sell the one which would provide him the higher commission; according to the agency theory, in fact, straight commission compensation systems (SCCS) lead to a conflict of interest between the agent's and the client self-interest (Kurland, 1995).

From an ethical perspective where ethics is defined according to the Oxford dictionary as "moral principles that govern person behavior or the conduction of an activity", we argue, in line with (Brown, 1988), that insurance activity is surrounded by a conflict of interest because people have a personal incentive to make a decision or act in a way that is not the best interest of another party of whom the person own such duty (IRMI, 2006).

If we pose our attention on the Spanish insurance brokers, this argument become even more articulated and interesting because the broker remuneration may come from two different sources (Soto, 2012): the insurance company (by means of commissions) and by the customer (by means of fees). To articulate our argument and provide a clear and simple

view on this issue, it is necessary, by means of practical examples, to take into consideration both agents and brokers and analyze the problem from both the perspectives.

We begin with the tied agent case. Suppose to have a customer willing to purchase an insurance policy for its new car; it is reasonable to think that he starts his research by looking at the most well known insurance companies, asks suggestions to friends and family, defines a set of potential companies and, finally, goes to the branches closest to his house to decide which products to purchase according to the benefit-cost ratio. Within this framework, the customer deliberately decides the company. However, the policy of its new car depends on what the agent proposes him.

Sometimes, for example, agents may be pushed by their company to sell specific types of policy instead of others including services which are not 100% necessary for the customer. In this situation, the selling process may be characterized by two potential conflict of interests: the commercial interest of the company to sell specific products and the commercial interest of the agent to sell the product which guarantees him the highest commission rate.

Let's switch now to the broker case where a customer has to purchase a policy for its new brand car.

In this case it is reasonable to think that the decision on the broker will be based on professional within its geographical area who are known and are recognized for being moral, rigorous and reliable. Once that the broker is chosen (who may be indicated by family, friends, etc), the professional assesses the interest of his new customer and goes to the market to look for the most suitable products for him. Similarly to the case above, we have again a conflict of interest since it is reasonable that the broker would offer the products of those companies which guarantee him the highest commission rate or those products which are particularly pushed by the insurance company.

Truth be told, with respect to the agent case, there is some regulation by the law and by the code in which all brokers are registered since brokers must show, at the end of the year, a proper balance of insurance companies within its portfolio. This is done to guarantee a professional behavior of the broker who does the interest of its client. This allows us to

claim that the straight commission system in the broker channel may somehow work thanks to the regulation.

As aforementioned, the whole service will then be charged by the fees. Little has been written about fees; brokers balance sheet does not reveal how these fees have been calculated and applied and institutional documents do not give particular indications on how they are regulated. In this opaque situation, we argue and wonder what is the real role of fees and how they are effectively calculated. To make it more clear, let us suppose that, in order to have a balanced portfolio to be compliant to the regulated constraint, the broker is forced to sell also the products of those companies offering the lowest commission rate since the broker has to show that he applied a certain equilibrium and since it, somehow, reduce the possible conflict of interest.

This loss in the income may be somehow recovered by charging the spread between the commission rate.

According to this, it is reasonable to think that for those products in which insurance companies offers lower commission rates to the brokers, the professional or the brokerage company will set a fee which will be based on two main components: the flat one deriving from its consulting activity (which may come from the quantity of effort spent by the broker) plus a sum equal to the spread between the average commission rate of the industry (in the US case we have seen that it is about 10%) and the commission rate paid by that company.

If the overall argument holds, we can argue that a regulation which somehow balance the conflict of interest between broker and customers may be somehow weakened by the possibility of brokers to charge the fees. To articulate our argument and provide a clear and simple view on this issue, it is necessary, by means of practical examples, to take into consideration both agents and brokers and analyze the problem from both the perspectives.

In our attempt we will first take into consideration a retail customer and a company assuming that the size of the customer is proportional to the size of the broker.

Let's suppose that a surgeon who work for a private hospital is required to hire an insurance policy for its civil responsibilities and some other insurance products linked to its working activity (insurance for its hands, sights are just few examples) plus some other products related to

his personal life (car insurance, house insurance, life insurance, etc.). Given the set of products he need and its purchasing power, we may expect this doctor to look for a broker which may assist him in the insurance business and take care of him for this bundle of products.

In this case it is reasonable to think that doctor will pick the broker within its geographical area and will choose those professionals who are recognized for being moral, rigorous and reliable. Once that broker is chosen, the professional will assess the interest of his customer and will look in the market for the most suitable products according to his needs. Subsequently, the broker will sell the surgeon that bundle of product and will receive a commission from the insurance company for his intermediation activity and (according to his commercial strategy) a fee from the surgeon.

In this case there might be a conflict of interest between the doctor and the broker because it is reasonable to think that the broker would offer to his customer the products of those insurance companies which would pay him the highest commission rate.

The issue discussed above is the most typical in the insurance market and this topic is everything but new; national authorities, in fact, already tackled this argument and oblige insurance broker to give proof that their portfolio is, in terms of volumes, balanced. In the Spanish case, for example, every six months all the brokers have to give evidences that their portfolio is diversified and balanced with the products of all the companies operating in the insurance market (this is analogous to the what so called "principle of autonomy" in the Italian Insurance Regulation).

The transparency of the broker portfolio becomes thus an important instrument to mitigate potential conflicts of interests because brokers are obliged to provide evidences that they don't pursue their own interest by selling only the products of those insurance companies offering them the highest commission rate.

However, some systems, like the Spanish one, may allow both commission and fees. In Spain, for example, when fees are charged, insurance brokers are obliged to inform the insurance company about the fee; in turn, the insurance company will communicate to the customer that policy has generated a certain commission rate.

In this context, it is straightforward that Spanish brokers are forced to sell also those products offering them lower commissions resulting with a decrease of their final remuneration. Thus, we claim that brokers may recover this “income reduction” by charging fees. From this perspective, in fact, it becomes reasonable to think that for low profitable products, brokers, may charge fees which we hypothesize to be calculated on the basis of a flat rate plus a variable component equal to the spread between the average commission rate paid by the industry (in the U.S. case we have seen that it is about 10%, but in the European market we expect it to be a bit higher) and the commission rate paid for that product.

According to this, we can come to the first conclusion (or, better defined, hypothesis) and, thus, claim that fees depend on the commission rate applied and that their role, in this case, is to mitigate a loss of income a broker has to face in his attempt to balance its portfolio.

Given this first example, we now may turn to the case study of a big customer implying the supporting activity of a broker of big dimension. According to this, let’s think about a multinational manufacturing company which has to subscribe an insurance contract for all the employees working in a Spanish factory. In this case, generally speaking, the manufacturing company would ask to a big broker to prepare an economic proposal for the supply of insurance policies.

In the moment, that the company and the broker find an agreement, the broker will charge a fee for its consulting activity and will gain also a commission from the insurance company he sold the product of. In this case it is sure that the broker will definitely charge a fee because of its presales activity implying (according to the high volume of the operation) time, personnel and other resources. According to this, it is thus reasonable to assume that the mere presentation of an economic proposal will imply the charge of a fee to guarantee to the broker a certain compensation for the preparation of the proposal.

Thus, once that the proposal is presented, the manufacturing company may act in three different ways: (i) it may accept it; (ii) it may refuse it and ask to other brokers for new proposals or (iii) it may negotiate (or renegotiate) with other brokers/ insurance companies an insurance contract on the basis of the proposal prepared by the broker.

In the third example proposed above, the manufacturing company would have an opportunistic behavior and would exploit the work per-

formed by the broker to negotiate with other financial intermediaries, the same products at a lower price.

In synthesis, we can also argue that for high volume contracts, the role of fees is to mitigate an opportunistic behavior of those customers whose aim is to use an economic proposal to lower the price and close agreements with other financial intermediaries.

5. CONCLUDING REMARKS

This paper focuses on the insurance broker remuneration and proposes a new perspective through which scholars may examine the compensation system of these financial intermediaries. In particular, after reviewing the literature on this topic (mainly theoretical and based on the trade-off between commission and fee-based remuneration systems), we proposed a discussion on the remuneration of insurance brokers and set up some practical examples in the Spanish market where both commissions and fees are allowed as means of compensation for the broker activity.

We suggested, in line with the literature on ethic in finance, that conflict of interests and opportunistic behaviors may emerge between brokers and customers. However, we proposed different lens through which this argument may be tackled and analyzed by means of two examples involving small brokers (and small customers) and big brokers (and big customers).

In particular we argue, in line with the literature, that commissions may drive unethical intentions (Kurland, 1996) when commission rates are below the average of the market; within these cases brokers may apply fees to both large and small customers to reduce the loss of income as consequence of the Spanish Regulation that imposes the brokers to have balanced portfolios involving products from different insurance companies with different insurance companies (offering different commission rates).

From this perspective, it is straightforward that some customers are going to pay more than others when brokers intend to compensate their lower commission rates with consulting fees. In this case, those customers are somehow paying the “cost” of the Regulation. According to this, we may also hypothesize that fees are calculated according to the com-

mission paid by the insurance company to the broker and that commissions and fees are inversely proportional.

In our example, we also discussed a case in which customers may have an opportunistic behavior. In particular, we argue that fees may be useful for insurance brokers since they may mitigate the opportunistic actions of those customers using the performed job of the brokers (i.e. economic proposal) to lower prices and find better agreements with other financial intermediaries.

In synthesis, the above examples suggest that charging fees does not imply an unethical behavior of the broker; brokers are in fact forced on one side to reduce their loss of income and, on the other side, to mitigate the opportunistic behavior of their customers. Scholars from different disciplines might be interested in developing the literature on this controversial topic; for example, this preliminary discussion paper may be extended in the following ways. Firstly, for those scholars researching on the broker's remuneration system, it could be interesting to tackle this argument in an empirical way: questionnaires or direct interviews may be powerful means to contribute to this vein of research.

Secondly, for those interested in the legislative perspective, a deep reflection on how to improve the current regulation may be welcome both for academic and regulatory purposes.

Thirdly, scholars concentrated on the ethics in the financial industry may somehow provide a comparison between insurance brokers and other financial intermediaries to discuss and develop theories on the basis of their different (or similar) compensation systems.

To conclude, we think that these open points together with the growing importance of this distributing channel represent a valid and a relevant topic to be treated in subsequent manuscripts.

Notes

1. See for a deeper analysis, for example, the Directive 2002/92/ EC on insurance mediation.
2. See for a deep analysis, for example, the Directive 2009/138/ EC (known as Solvency II Directive which follows the first directive published in 1973).

3. Insurance Europe is the European insurance and reinsurance federation whose members are the European national insurance associations.
4. To get more information regarding this status, it may be interesting to take a look at the Directive 2004/39/EC on Markets and Financial Instruments (MiFID) and, in particular, to the Article 545-1 of the monetary and Financial Code.
5. For more details regarding the requirements, check article n. 27 published in the law 26/2006 by the "Jefatura del Estado" on the BOE n. 170, 18th June 2006.

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