TRANSPORT RISK
Transport Risk Management Inc.

The Hidden Costs of Aviation Insurance

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Most of us have read the recent news concerning the insurance industry and regulatory violations associated with some of the largest publicly traded insurance brokers in the world. While this article is not intended to explain or address the specifics of the entire issue, it is intended to point out some of the most common and identifiable practices found in the insurance industry that may add to your insurance premium. If the consumer is aware and able to identify those practices, some measure of control is added and provides the client some ability to significantly reduce parasitic or non-premium related insurance costs.

Before we can identify hidden costs, we must first understand how the premium payment system works and the basis upon which each party either pays, or is paid. Because state insurance regulations and licensing structure require that an agent or producer be used to transact nearly all aviation or aerospace insurance between the client and the insurance company, the agency is the one common thread that exists through nearly every transaction. Whether it be the placement of coverage, or the procurement of premium financing, all information and funds flow through the agency in all directions excepts claims.

Fees and Commissions

Insurance agencies receive primary payment for transacting insurance in two ways, either in commissions agreed upon and paid to them by the insurance carrier, or fees agreed upon and paid to them by the client. Most states include regulations that stipulate payments to agencies can be either commissions or fees but not both. Occasionally additional fees may be associated with some other type of service provided to the client or are disclosed and agreed to between the agency and the client.

In the case of commissions, the percentage of gross premiums to be paid to the agency is agreed upon between the agency and the insurance company. The client is not required to be party to that agreement and premiums are quoted to the client on a gross basis.

When producer services are provided on a fee basis, the producer and the client agree upon a set amount or fee to be paid to the producer and is not typically tied to the gross premium on a percentage basis. The producer then advises the insurance company that they are working on a fee and requests the insurance company to provide a net quote. The net terms provided by the company are exclusive of commissions and are billed to the producer on a net basis and passed directly through to the client with the addition of the fee.

The Premium Flow

Upon binding coverage on behalf of the client, the agency invoices gross premium amount to the client if placed on a commission basis and the net premium amount if on a fee basis. The payment is typically paid by the client to the agency which then deposits the premium into an interest bearing trust account until invoiced by the insurance company. The agency in turn makes payment to the company on the client's behalf when due or when it appears on their company statement. The time period, if any, between receipt of payment from the client and when payment is made to the company is called the float. Like premiums, commissions are not earned until coverage is provided therefore any change in coverage which results in a credit to the client must include the unearned portion of the premium and commissions received by the agency and returned to the client. Fees are most often fully earned at policy inception therefore any change in coverage that results in a credit to the client would not typically include any return of the fee to the client. The time period, if any, between receipt of return premium by the agency from the company and when premiums are returned to the client is called the return float.

Annual Premium Versus Payments Provided by the Insurance Company

When annual premiums are required at policy inception, you are essentially fronting the agency and the insurance company premium dollars for future coverage.

In the cases where quarterly or monthly payments are allowed by the carrier, premiums are still required in advance of coverage however the time in advance is much shorter. Instead of having the premium or commission dollars available to use 365 days in advance, the agency and insurance carrier have just 30 to 90 days use of the funds.

Once coverage is placed and premiums are paid by the client on an annual policy, the premium is earned at the rate of 1/365th each day that coverage is provided as is the commission to the agency. The agency and the company are then able to use those premium and commission dollars to generate interest or other safe investment income until they are earned. Those funds must be kept in trust, reserve, or invested safely until they are earned because they must available to be paid back to the client if coverage is cancelled or changed. In the mean time however, both were able to use the client's funds.

Earnings generated in this manner by the insurance company are known as investment profits as apposed to underwriting profits and is an acceptable business practice in the insurance industry.

The Hidden Costs – Lost Investment Opportunity to the Client

Advanced premium payments are standard in the insurance industry (most consumers would opt to pay for coverage after the loss has occurred), and is an acceptable business practice. In many cases however, the insurance company is willing to offer monthly or quarterly payments to the client particularly on large premium accounts thus allowing the client to maintain use of their own funds until the next payment is due. Since the agency must also forgo receipt of their annual commission in advance when payment terms are provided, it is not uncommon for those payment terms to be withheld from the client by the agency.

Additionally if the client makes a decision to change agencies mid-term, the original binding broker is not required to return the unearned commissions that were paid to them. This responsibility becomes that of the new agency and therefore removes a significant benefit to the new agency and introduces significant risk to the new agency if the client cancels or changes coverage requiring a return of commission. Since there is little benefit to the new agency and requires significant financial risk, a new agency will many times decline to take over an account mid-term. When this happens, the client loses much of their ability to move to a new agency even when they feel that it is in their own best interest to do so.

Return Premium to the Client

When a policy is changed or cancelled, the unearned premium and commissions are returned back to the client. Sometimes a short rate scale is used to calculate the return amount however the same principal applies. The carrier returns the net credit to the agency; the agency then adds the unearned commission and then returns the gross premium credit to the client. If the placement was made on a fee basis, fees may be fully earned and a net credit is returned to the client.

The Hidden Costs – Untimely Return Delaying Use of Funds to the Client

Most business run their accounting systems on some type of regular cycle and insurance agencies are no different. Many agencies are on a 30 day cycle therefore when a policy change or cancellation is made, the credit from the insurance carrier may not appear on their statement for up to 30 days depending upon when the change occurred. Upon receipt of the credit from the insurance company, the credit may then be placed on the next cycle for payment or return to the client. In extreme cases and depending upon the timing and the flow of information through the agency, the payment cycle may reach 90 to 120 days before the credit is returned to the client. During much of that time, the agency is generating interest on the return premium funds in a trust account or other investment. This return delay can be exacerbated when premium financing is used (see below).

Premium Financing

Premium financing can be a very valuable tool to both the insurance companies and the clients alike. If annual premiums are required and the client is unable to pay the full annual premium in advance, they are often offered premium financing as a means to break down the large annual premium into manageable smaller payments over time. When premium financing is used, the client makes a down payment plus the first monthly payment directly to the agency. The premium finance company then pays the remainder of the annual premium to the agency on the client's behalf as a loan to the client at some agreed upon interest rate.

The Hidden Costs – Additional Production Fees and Motivation to Annualize Premiums

As an incentive to agencies, many premium finance companies provide a production fee to agencies that send them business. This is usually realized either as an advance to the agency and paid back through added pints to all finance contracts generated by the agency or paid on a per contract basis through the addition of points to the each finance agreement. The standard fees generated in this manner are typically 1% to 3%. Some states require that premium finance fees be disclosed to the client however since in the case of advance payments to the agency, the fee was not added to the specific contract therefore disclosure may not be required.

When premium finance agreements are placed, the client must also give a limited power of attorney to the premium finance company which allows the premium finance company to cancel the policy for non-payment of premium in the event that the client does not make payments per the agreement. Additionally, because the premium finance company has an interest in the unearned premium on the account, any credits or return premium must go through them before being returned to the client. This situation can result in prolonging the actual return of any credits or return premium to client as well.

Since the agency stands to gain significant returns in the way of premium finance production fees or, must pay back advances from the premiums finance company through production fees, there exists a motivation to agency push a client into annualized premiums as well as adding points to the contract. When that happens, the client not only pays an additional 1% to 12% in interest and fees as well as loses significant use of their money while credits are transferred through another party prior to being returned to the client.

Fees Added to Commissions

Most states disallow the addition of fees to commissions and require that any fees be agreed upon between the client and the agency. It is not uncommon to see a fee added for travel, meals, or other expenses associated with the account by an agency and billed to the client as a fee or expense for services other than the placement of insurance.

The Hidden Costs – Additional Fees and Cost to the Client

We have seen these expense or fees added to polices reach as high as 25% of the total annual premium.

Contingency Payments or Production Fees

A contingency or additional commission may be offered or paid by an insurance company to an agency that reaches certain levels of production or production goals. Contingency payments are not uncommon in the insurance industry however they are less common but do exist in the aviation specialty markets.

The Hidden Costs – Potential for Placement with a Less Competitive Company

There is a strong motivation for the agency to place business with the less competitive company or not present more competitive quotes to the client because the agency stands to earn a higher commission in return for production levels.

We at Transport Risk Management, Inc. are committed to providing all of our client's complete transparency with regard to their insurance program and to how the program was placed. This has always been the basis of our commitment to our clients and is in large part the reason that Transport Risk Management, Inc. exists today. Transport Risk Management does not, and has never, participated in the above business practices. To the extent that we are able to help control our client's risk management cost through the elimination of additional fees and other non-premium, non-value added, parasitic pricing, the more resources that are available to our clients for the development of loss prevention programs within their organizations. Those financial resources are much better utilized to support crew training, equipment upgrades, and employee safety programs by our clients and result in a much stronger financial return.

We feel strongly that client education, financial welfare, and loss prevention are paramount and second only to providing each client with the finest coverage and risk management services available. The better educated our clients become with regard to their insurance and risk management programs; the better able they are to take some measure of control and responsibility over their exposure and the associated costs. Lower losses benefit our industry as a whole and therefore our collective futures. Lowering the exposure and risk we represent to ourselves and the insurance companies committed to supporting our industry will in turn lower the cost of managing that exposure.