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UNIVERSITY OF SOUTHAMPTON
FACULTY OF BUSINESS & LAW
SCHOOL OF MANAGEMENT

**Insurance underwriting and broking in the London
insurance market:**

**The role of reputation and trust in the insurance
decision making process.**

By

Michael Zboron

Thesis for the degree of Doctor of Philosophy

February 2015

UNIVERSITY OF SOUTHAMPTON

Abstract

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By Michael Zboron

The importance of reputation for corporations is increasingly acknowledged and it is generally recognised that a good corporate reputation can create a competitive advantage. The even higher relevance of reputation for the insurance sector due to the intangible nature of its products is also accepted. Trust is also seen as vital for business transactions in general and for insurance transactions in particular. However, based on the literature review there is no generally accepted definition of reputation and trust. There is also no consensus how these two concepts differ or how they interact. This thesis argues that reputation is created through the evaluation of previous actions by individuals and organisations and can function as information surrogate, which in turn enables individuals to trust or mistrust a partner in a transaction. Trust is seen as a means of reducing the complexity of decisions under uncertainty.

This study adopted a qualitative research methodology with the aim of exploring what role reputation, but also the similar concept trust, plays in the insurance underwriting and broking process, with a particular focus on the London insurance market. In addition, the consequences for business relationships between underwriters and brokers as a result of a negative reputation were investigated. Another aspect of this research was to find evidence whether the concepts of reputation and/or trust can be considered as heuristics in relation to decision making under uncertainty thus reducing the complexity of decisions.

Through the interviews conducted and the web-based surveys there is evidence, albeit inconclusive, that reputation` and trust are part of the decision making process of insurance underwriters and insurance brokers alike. A positive or negative reputation impacts trust and hence impacts business relationships in the London Market. There are also indications that the reputation of brokers influences how underwriters assess the risks presented by brokers. During interviews a number of underwriters stated that they would trust the verbal representations of brokers if they have a positive reputation rather than reading through the entire submission document, which can be quite large. In addition, there is evidence that underwriters might be more inclined to accept new risks from brokers which they believe they can trust. Another conclusion is that the way insurers handle claims significantly influences how brokers place business in the London Market, especially for long-tail business. This highlights the intangibility of the insurance product and hence the need for insurance intermediaries and buyers to rely on reputation as part of the decision making process.

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Declaration Of Authorship

I, Michael Zboron, declare that this thesis and the work presented in it are my own and has been generated by me as the result of my own original research.

Insurance underwriting and broking in the London insurance market:

The role of reputation and trust in the insurance decision making process.

I confirm that:

1. This work was done wholly or mainly while in candidature for a research degree at this University;
2. Where any part of this thesis has previously been submitted for a degree or any other qualification at this University or any other institution, this has been clearly stated;
3. Where I have consulted the published work of others, this is always clearly attributed;
4. Where I have quoted from the work of others, the source is always given. With the exception of such quotations, this thesis is entirely my own work;
5. I have acknowledged all main sources of help;
6. Where the thesis is based on work done by myself jointly with others, I have made clear exactly what was done by others and what I have contributed myself;
7. None of this work has been published before submission.

Signed:

Date:

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1 Introduction

The motivation for this thesis stems from the author's experience in the insurance industry, both as an underwriter and an insurance analyst. The initial interest in the general concept of reputation moved to a more specific focus on what role reputation and the related concept trust might play in a unique insurance market place, the London insurance market. An additional point of interest is whether there is evidence that reputation and trust can reduce the complexity of business decisions as argued by, for example, Fichtner (2006), and how this might fit into existing theories of decision making under uncertainty.

Although the generic concept of reputation and trust will be explored, the main emphasis is on whether there is evidence that underwriting or broking decisions might be alleviated through the reputation of individuals or organisations in the London insurance market in the sense of an information surrogate suggested, for example, by Eberl (2006) or by Vogt (1997). In addition, the concept of trust as a means of reducing the complexity of decisions as proposed by Luhmann (2009) and how the concept of reputation and trust might interact will be investigated. In order to put these two concepts into context, an overview of how the London insurance markets functions, including legal considerations and issues arising out of the placing process, will be provided.

The importance of reputation for corporations is increasingly acknowledged and it is recognised that 'a good corporate reputation is a highly prized intangible asset' (Rayner, 2003 p 2). The risk of a damaged reputation is also a major concern amongst risk managers (Economist Intelligence Unit, 2005). Atkins et al (2006) point out that the behaviour of individual employees can seriously damage the reputation of an organisation either because of inappropriate behaviour vis-à-vis colleagues or how employees treat customers or suppliers. The concept of (corporate) reputation has been increasingly explored in academic research since the early 1990s and researchers have attempted to come up with a definition which is generally accepted (e.g. Wartick, 1992, Yoon et al, 1993, Formbrun, 1996, Gotsi and Wilson, 2001, Rayner, 2003, Barnett et al, 2006). However, despite increasing research in this field 'a precise and commonly agreed upon definition is still lacking' (Barnett, 2006, p 26).

Similar to the concept of reputation, the importance of trust is widely recognised, in particular for the insurance sector due to intangible nature of its products (e.g. Schanz, 2006 and Herger, 2006). However, there also remains a diversity of definitions of trust (Mayer et al, 1995), and Moellering (2001, p 404) argues that many researchers 'take the concept of trust for granted.' Furthermore, there appears to be limited research on how reputation and trust might interact, which Scott and Walsham (2005) find surprising. Notwithstanding this, Vogt (1997), for example, highlights the essential role reputation plays as information provider for the build-up of trust in economic transactions.

The London insurance market is a specialist market for risks which cannot be easily placed elsewhere and benefits from the close proximity of underwriters and brokers in the Square Mile of the City of London (TheCityUK, 2011). This in turn enables underwriters and brokers to build close business relationships between market participants through face-to-face negotiations. Jarzabowski et al (2010) add that these business relationships also allow the formation of personal relationships where trust plays an important role for underwriters or brokers when judging whether to do business with each other.

Williamson (1979) and Fichtner (2006) point out that all business transactions comprise an inherent element of uncertainty which Nerd (2002) puts down to incomplete information about the transaction partner, for example, in respect of the actual behaviour once a contract has been concluded.

Insurance underwriters' decisions about accepting risks from another party (policyholder) are inherently decisions under uncertainty (Kunreuther et al, 1995). Insurance underwriters are thus not only faced with the general uncertainty of market transactions, but also with the uncertainty whether and how many claims will occur and the pay-out for these claims. It is therefore necessary to understand some of the relevant concepts of decision making under uncertainty. Hahnemann and Tversky (1979) challenged the assumption that decisions made under uncertainty are based on expected utility by introducing the so called 'Prospect Theory' which, inter alia, takes into account the risk attitude of the individual when making decisions. Tversky and Kahneman (1974) also established the theory that individuals use so called 'heuristics' when making decisions under uncertainty. These heuristics are regarded short-cuts for complex or uncertain decisions which, however, can result in biases. However, the idea that the use of heuristics can lead to biases is challenged by Gigerenzer and Gaissmaier (2011, p 456) by claiming that heuristics have the goal of making 'fast and frugal' decisions by ignoring certain parts of available information. Trust could potentially be considered as heuristic as it can help

to reduce the complexity of decisions (Luhmann, 2009). For example, underwriters might be more comfortable with accepting a risk when they can trust the broker that the information provided to assess the risk is a fair and true picture of the risk to be insured. In addition, the London market is a subscription market where the lead underwriter typically negotiates the terms and conditions with the broker and other underwriters just follow (CII, 2010). However, these follow underwriters accept the terms and conditions only if the lead underwriter's judgement is trusted (Thoyts, 2010).

Insurance brokers, on the other hand, have to deal with the nature of insurance as an intangible good (Farny, 1995) where the willingness and the ability to fulfil a contract by the underwriter can only be tested when a claim occurs. Reputation can potentially provide information about an underwriter's claims handling history thus enabling the broker to trust the underwriter.

Closely related to idea of market uncertainty is the concept of transactions costs which Coase (1937) introduced. For market transactions Coase (1960, p 15) also provided a definition of transaction costs:

'In order to carry out market transactions it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal with and to what terms, to conduct negotiations leading up to a bargain, to draw up a contract, to undertake the inspection needed to make sure that the terms of the contract are being observed and so on.'

Furubotn and Richter (2005, p 47) posit that transactions costs will always be incurred by individuals because of limited time and cognitive resources: 'To say that individuals have to use time and resources to secure information, and that they have limited ability to process data and formulate plans, is merely to make reasonable assumptions concerning the nature of the decision makers in an economic system. [...] Because of their human limitations, their restricted knowledge, and their tendency to make errors, real-world decision makers will always function inefficiently relative to the hypothetical decisions makers of neo-classical theory. In short, transactions costs attributable to this inefficiency must arise. Transactions costs are encountered *universally*¹ because of the character of the individuals who make decisions.'

Other aspects which need to be considered in the context of economic transactions are asymmetric information of which the principal-agent problem is part of. Asymmetric information is an information advantage of the agent over the principal (Fichtner 2006). This

¹ Italics by authors

information advantage is well illustrated by Akerlof (1970, p 489) who explained this phenomena by using used car dealers as an example whereby a buyer of a used car cannot be sure whether he is buying a good car or what Akerlof (1970) defines as a 'lemon' or bad car. Here the seller of the car has an information advantage as the seller will have a better idea of the quality of the car. In respect of an insurance contract, the principal is normally the policyholder and the agent is the insurer. In the context of the principal-agent relationships (Ripperger, 2003) claims that trust can overcome some of the agency problems because of the absorption of behavioural risks connected with asymmetric information. Furthermore, (Ripperger, 2003) argues that trust could be considered as an implicit contractual relationship hence trust could be also be modelled as a principal-agent relationship.

Closely related to asymmetric information are adverse selection and moral hazard. The former deals with the selection of a contractual party which does not fulfil its contractual obligations whereas the latter is concerned with hidden actions or intentions of a contractual party which the other party was not aware of or cannot control (Fichtner, 2006). Given the nature of an insurance contract these two concepts are very relevant; however, they can affect both insurers and policyholders.

Given the uncertainty about market transactions, the question is whether market participants are using other instruments to deal with this uncertainty. Reputation and trust can play a role in reducing this uncertainty. Fichtner (2006) argues that where parties are doing business and where there is an information disadvantage by either one or all parties then there should be sanction mechanisms available which allow market participant to form business relationships which are efficient and which enable all parties to carry out business transactions. Reputation can be such a mechanism as it provides information about the behaviour of a business partner. In respect of trust, Luhmann (2009) highlights that trust is important in all ways of life as a means to reduce the complexity of decisions whereas Ripperger (2003) emphasises trust in the context of complex economic transactions as a mechanism to stabilise uncertain expectations.

In recent years, there has been an increasing research focus on how either underwriting or placing decisions are made in the London insurance market. An earlier research is from Ayling (1984) who discussed how the London market operates, in particular when assessing natural catastrophe risks, and conceded that looking into behavioural aspects of underwriting might be more appropriate than focusing on traditional or normative decision theories.

More recent examples include, Keykhah (2000) who looked into reinsurance underwriting, in particular catastrophe reinsurance underwriting, Kyriakou (2002) who looked into the behaviour of London market participants when it comes to contractual disputes, Jarzabowski et al (2010) who compared the differences in reinsurance underwriting between London and Bermuda and Baublyte et al (2012) who considered Political Risk underwriting in the London Market. All of these studies recognise that there is strong role for either reputation or trust in the London insurance market as part of the underwriting or placing process by brokers. However, whilst this role is acknowledged there is neither a theoretical discussion about these two concepts, let alone a definition of reputation and trust. Nor is there a discussion how these two concepts interact in the decision making process; a gap which this thesis aims to narrow.

Lloyd's of London, one of the largest insurance markets world-wide, published two reports (2010 and 2012) relating to concepts of behavioural decision theory and how they could be relevant for underwriting decisions. Although these two reports only discuss concepts without providing empirical evidence, they are nonetheless an indicator that there is an increasing awareness in the London insurance market about the role of subjective or qualitative factors which could influence the decisions of underwriters to accept risks and brokers to place risks. Behavioural economics, which is concerned with how individual make economic decisions, has attracted a growing interest since the last quarter of the 20th century (Loewenstein, 1999) and there have been increasing efforts, in the wake of the Lehmann Brothers collapse, to try to understand how banks make decisions under risk. Camerer and Loewenstein (2004, p 3) claims that understanding behavioural economics 'increases the explanatory power of economics by providing it with more realistic psychological foundations.' Even the Financial Conduct Authority (FCA) has started looking into how understanding behavioural economics might provide insights as to how consumers make financial choices (Erta et al, 2013)

1.1 Research Objectives

This thesis aims to identify how reputation and trust influences the insurance decision making process, with a particular focus on insurance underwriting and broking in the London insurance market. To date, there has been limited research as to how reputation and trust interact with underwriting activities and the broking process in this specific market place. In order to achieve the main research objective the following sub-objectives will be considered:

1. To provide a comprehensive literature review on generic concepts of reputation and trust;
2. To investigate the concepts of corporate image and corporate identity and how they differ from reputation;
3. To explore what general role reputation and trust might play in business decision processes;
4. To examine what specific role reputation and trust might play in the insurance sector;
5. To investigate what existing concepts of behavioural decision theory might be relevant for the insurance underwriting process;
6. To explore how reputation and trust influence decisions by underwriters, brokers and insurance buyers;
7. To investigate whether there is evidence that reputation and/or trust could be utilised to reduce the complexity of underwriting and broking decisions.

1.2 Research Methodology

A phenomenological paradigm will be adopted for this study. Within this paradigm, an inductive approach, an exploratory strategy and a qualitative research method are considered appropriate to explore the research questions.

1.3 Structure of the Thesis

This study is divided into nine chapters.

The first chapter briefly describes the motivation for this thesis and introduces the main issues to be explored. In addition, the research objectives and the methodology will be presented.

Chapter 2 will provide an overview of the concept of insurance and the main participants in the insurance market place. Furthermore, the London insurance market, including Lloyd's of London and its unique setup in the City of London will be explored. Chapter two will also consider the role of intermediation and how corporate clients purchase insurance. Additionally, a description of how insurance is placed in the London market, together with legal considerations and issues arising from this placing process, will be provided.

Chapter 3 will review the literature in respect of the general concept of reputation. In addition, a review of the literature in respect of similar or related concepts of reputation, such as image, identity and trust, will be provided. Based on the conclusions from this review, Chapter will develop a general definition of reputation and adopt the definition of trust suggested by Luhmann (2009). Finally, the specific relevance of reputation and trust for the insurance sector will be examined.

Chapter 4 will explore relevant aspects of descriptive (behavioural) decision theories which argue that human beings do not necessarily make rational decisions when faced with uncertainty or risk. This chapter will also introduce two reports published by Lloyd's of London which discuss the relevance of risk perception and decision theories for underwriters.

Chapter 5 will investigate the relevance of decision theory for insurance underwriting. Furthermore, the reliance on mathematical concepts for underwriting decisions will be challenged in light of research findings on human behaviour under uncertainty. In addition, this chapter will provide an overview of existing research on decision making in insurance.

Chapter 6 will consider the research design and methodology. In particular, the appropriateness of a grounded theory research approach and how research data is collected will be discussed. The advantages and disadvantages of semi-structured interviews with market participants in the London insurance market will also be evaluated. In addition, the design of the web-based survey with underwriters will be outlined and problems encountered, both in respect of interviews and the surveys will be highlighted.

Chapter 7 will discuss the salient points of these interviews and expand the insurance decision map to incorporate new pertinent findings from the interviews with market participants.

Chapter 8 will discuss the results of the web-based survey amongst underwriters in the London market.

Chapter 9 will provide an overall conclusion and discussion of the findings of study. Furthermore, the contribution to knowledge and suggestions for future research will be highlighted.

2 The provision of insurance and market participants

2.1 Introduction

The roots of insurance can be traced back to around 1790 B.C. (Thoyts, 2010) where the legal code of the Babylonian King Hammurabi provided for the compensation of robbery. The first insurance contracts are closely linked to shipping activities and the first marine insurance policy was concluded in the 14th century in Genoa, Italy (Romeike and Mueller-Reichart, 2005). In the United Kingdom (UK), the concept of insurance is also closely linked to shipping activities and the first insurance contract dates back to 1547 (Thoyts, 2010). The first life assurance policy in the UK followed closely after this in 1553 where a William Gibbons insured his life for the sum of £382 (Thoyts, 2010). An important milestone in the development of modern day insurance is the establishment of Lloyd's of London which started in a coffeehouse owned by Edward Lloyd in the City of London in 1688. Initially a trading place for seafaring customers the coffeehouse evolved into a market place for marine insurance and Lloyd's of London remains of the largest market places for specialist insurance, including marine (Herschaft, 2005).

This chapter introduces the main features of insurance and highlights the main insurance market participants in the United Kingdom. Following from this, the London insurance market and its participants, which are the main focus of this thesis, will be explained. This includes an introduction into underwriting in the London insurance market, underwriting cycles, the role of intermediation and corporate insurance buying. In addition, specific issues arising out of underwriting and broking process in the London insurance market will be discussed.

2.2 The concept of insurance

Although there is no uniform definition available as to what constitutes insurance, most researchers agree that insurance has to involve a risk transfer from one party (buyer) to another (insurer). Rejda (2008, p 19) offers the definition of the Commission on Insurance Terminology of the American Risk and Insurance Association which states:

'Insurance is the pooling of fortuitous losses by transfer of such risks to insurers, who agree to indemnify insureds for such losses, to provide other pecuniary benefits on their occurrence, or to render services connected with the risk.'

Based on the above definition four main characteristics of insurance can be deduced:

- **Pooling of losses:** This means that claims can be spread across a large portfolio of risks;
- **Payment of fortuitous losses:** This is a loss that is unforeseen, unexpected and occurs as a result of chance;
- **Risk transfer:** This means that the risk is either fully or partially transferred from the insured to the insurer;
- **Indemnification:** This means that the insurer settles a claim (i.e. makes a payment), so that the insured's (financial) position is restored to prior to the claim happening.

Farny (1995) adds to the above mentioned features that insurance is an intangible (immaterial) product which involves a transfer of risks from an individual to a collective risk taker (insurer) and requires a sufficient large numbers of policyholders, so that premiums paid by these policyholders can pay for the claims of a smaller number of claimants. Insurers use statistical methods to calculate premiums based on the probability of claims happening and the amounts to be paid out. Pooling of risks works well, when there is a large portfolio of insured risks, such as household insurance. However, insurers face a challenge when they are asked to insure unique, complex or volatile risks, such as a satellite launch or risks related to natural catastrophes. Such speciality risks are very often placed in the London insurance market.

English courts have focused on the legality of insurance contracts which also provides a definition what insurance constitutes. In the case *Prudential Insurance Co v Inland Revenue Commissioners [1904] 2 KB 658* a criteria for an insurance contract was established. An insurance contract is an agreement in which for “some considerations, usually but not necessarily in periodical payments called premiums your secure yourself some benefit [...] upon the happening of some event. Then the next thing that is necessary is that the event should be one which involves some amount of uncertainty”. Schulenburg (2008) adds two more features to the characteristics of insurance:

- The decision to buy the product insurance will also be made under uncertainty, unless the buyer plans to use the insurance in a fraudulent way, i.e. the buyer already knows that a claims has happened or will happen in the future. Consequently, insurance has a time dimension in the sense that there is normally a time lag between the conclusion of the insurance contract and the claims event.
- Insurance is not a transaction at a point in time, but rather stretches over a period of time. The quality of the product can only evaluated through past experience which is projected into the future. Insurance is therefore a product where uncertainty about the quality plays

a role as the policyholder cannot be certain whether the insurer can or will keep the promise it has made.

The risk transfer function of a non-life insurer generates a number of activities which are necessary to fulfil this role. Rejda (1998) sees the following main activities of a non-life insurance company:

- Rate making
- Underwriting
- Production
- Claims settlement
- Reinsurance
- Investments

All of these main activities can be split up into sub-activities. For example, underwriting requires, inter alia, the assessment of risks, the calculation of risk adequate premiums and the acceptance of risks. All of these activities can influence the financial performance of an insurer in one way or another. However, underwriting is probably the most important task of a non-life insurer, thus being the largest source of potential decision errors.

There are three main participants in an insurance market: insurance buyers, intermediaries and insurers. There are also other parties which may be involved in insurance business, such as asset managers or claims adjusters (Thoyts, 2010).

Insurance buyers are mainly private or commercial clients. Insurers can be split into mutual (which are owned by policyholders) or proprietary companies (which are either privately owned or owned by shareholders). Intermediaries include professional insurance brokers, independent financial advisors (IFAs) and tied agents. Insurance is also distributed through bank branches, supermarkets and especially on the retail side through comparison websites (Youngman, 2012). In the UK, insurance providers include Lloyd's Syndicates and Protection & Indemnity (P&I) Clubs. There are also Lloyd's brokers which specialise in broking business to Lloyd's Syndicates. A summary of the structure of the UK insurance market is shown in Figure 1:

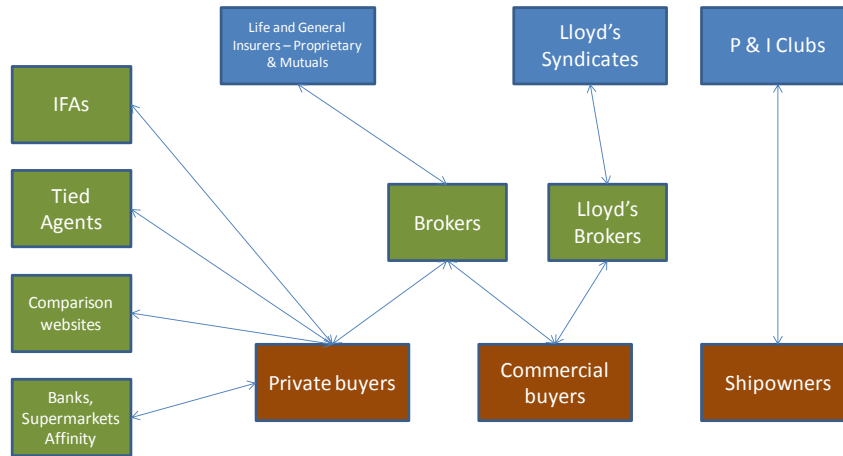


Figure 1 UK insurance market participants (based on Thoyts, 2010)

2.3 The London Insurance Market and its underwriting practices

The London insurance market is one of the most important international markets. According to research by TheCityUK published in December 2011 (TheCityUK, 2011, p 12), the London market is the world leading market for internationally traded insurance and reinsurance. The report also points out that it ‘enjoys a unique status in the global insurance industry as it offers a market place for those risks that cannot be easily placed in local markets [...]’ The proximity of the main participants, insurers (underwriters) and brokers, who all have offices in the Square Mile of the City of London is forging close ties and enable an easy flow of information which provides a competitive advantage (TheCityUK, 2011) compared to other market places, such as Bermuda.

The London market actually comprises three main sub-segments: The Company market, Lloyd’s of London and the Protection and Indemnity (P &I) Clubs. The market’s gross premium income was approximately £41.7bn in 2011, the majority of which is generated at Lloyd’s of London followed by the London company market (TheCityUK, 2013). However, the premium written by company insurers is difficult to estimate as UK insurers do not provide a split of premiums and other European insurers are increasingly using European Union (EU) pass-porting rules (which allows insurers within the EU to be licensed by the domestic regulator for the entire EU, (Third Non-Life Directive, 1992) to write business through branches rather than subsidiaries (for example, Allianz Global Corporate & Speciality is based in Munich, but has established a branch in London).

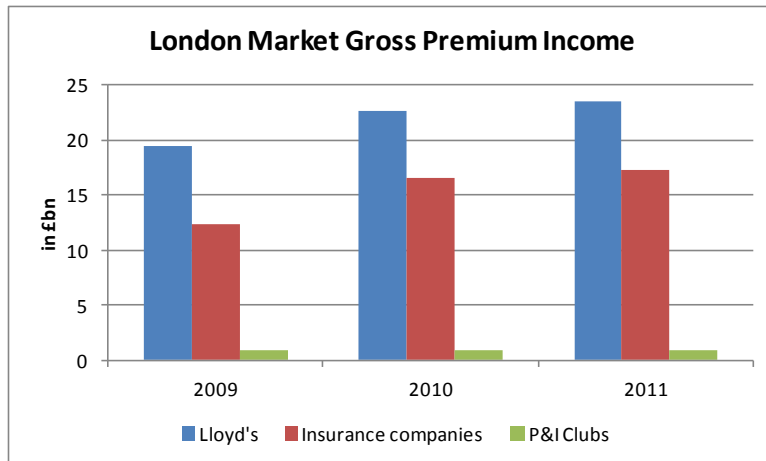


Figure 2 London market premiums (Source: TheCityUK, 2013)

Company market: All insurers which are providing underwriting capacity outside Lloyd's of London and which are not P&I Clubs are part of the company market. Most of the largest global insurers and reinsurers have offices in the City. These include, AIG, AXA Corporate Solution (part of AXA France), Allianz Global Corporate & Specialty (part of Allianz Germany), Zurich Global Corporate (part of Zurich Switzerland), Scor Reinsurance, Munich Re and Swiss Re

Lloyd's of London: Lloyd's of London is a unique vehicle as it is actually not an insurer, but a market place. Business is written through insurance Syndicates which provide underwriting capacity on an annual basis. However, on a combined basis Lloyd's would be the world's sixth largest reinsurers, according to A.M. Best, and one of the largest commercial insurers (see Table 1)

Table 1 Top 10 Global Reinsurers (Source: A.M. Best, 2013 a)

Top 10 Global Insurers		
Ranking	Company Name	Gross Written Premiums 2012
1	Munich Reinsurance Company	\$37,251
2	Swiss Reinsurance Company Limited	31,723
3	Hannover Rueckversicherung AG	18,208
4	Lloyd's	15,785
5	Berkshire Hathaway Inc	15,059
6	SCOR S.E.	12,576
7	Reinsurance Group of America Inc.	8,233
8	China Reinsurance Group	6,708
9	Korean Reinsurance Co	5,113
10	Partner Re Ltd	4,712

Protection and Indemnity Clubs (P&I): The P&I Clubs are mutual insurers where the policyholders (mainly ship owners) are also the proprietors. They typically provide insurance cover for risks which are not covered by Lloyd's or other marine insurers, such as collision damage and liabilities for loss or damage to cargo or pollution (TheCityUK, 2011). However, the idea was also to make ship owners less dependent on the volatility of capacity in traditional markets.

The advantages of the London market were highlighted by Robert Hiscox, the former CEO of Hiscox Insurance: 'The London Market is still the overall king of insurance markets. We have the huge advantages of the whole infrastructure of London, the expertise, the culture, the language, the time zone [...]. London see a huge variety of risks... and most of the hairy ones [...].' (Hiscox, 2013) However, the London Market Group, which is tasked with modernising the London Market, came up with a SWOT analysis based on interviews with market participants. The SWOT analysis in Table 2 points to a number of strengths, but also a number of weaknesses and threats:

Table 2 SWOT Analysis (Source: London Market Group, 2013)

Strength	Weakness
<ul style="list-style-type: none"> - London retains an advantage in underwriting expertise - London's reputation for paying claims remains a competitive advantage - London provides access to capital with an appetite for large and specialist risks - The cluster remains a powerful advantage; it provides an unrivalled method for exchanging knowledge. - "It is no surprise that we are having these discussions here. You couldn't do this in any other centre." - Subscription remains the best way to get difficult risks written (even if clients don't necessarily value it) - "Subscription is of significant benefit to carriers as it helps to manage our exposures 	<ul style="list-style-type: none"> - Price - Ease of access to the market for clients - Speed of placement - Speed of claims settlement - Speed of delivery of evidence of cover - Speed of endorsement agreement - Inflexible underwriting approach
Opportunities	Threats
<ul style="list-style-type: none"> - Brokers remain keen to see London market preserved - Brokers keen to engage in conversations aimed at bringing more business to London 	<ul style="list-style-type: none"> - Plentiful global capital supply - Rise of alternative capital sources - Growth of intellectual capital in other insurance centres - Desire of insured/producing broker to place business in local markets wherever possible - Clients attitude to subscription

2.3.1 Underwriting activities

Underwriting is the most important activity of a general insurer. The risk transfer, as mentioned in Section 2.2, requires the assessment of the risk in order to calculate the appropriate premium which the insured should pay. This process is called underwriting. The individual who acts on behalf of the insurers is the underwriter and his/her responsibility is to consider 'the facts presented [...] and decides whether to offer terms, request additional information or decline the risk. If the terms offered are approved by the insured, the underwriter will accept the risk in exchange for payment of a premium' (CII, 2010, p 9/2). This thesis will focus on the underwriting activities in the London insurance market with its unique features, in particular being a specialist market for risks which cannot easily be placed elsewhere and the close proximity of underwriters and brokers in the Square Mile of the City of London (TheCityUK, 2011).

Underwriting in a subscription market

The London Market is known as a 'subscription market' (CII, 2010, p 9/3) which means that the risk offered by an intermediary is spread between a number of underwriters depending on what percentage of the risk they wish to accept.

However, terms and conditions are typically negotiated between a leading underwriter and the broker. This underwriter is 'the first underwriter on the slip' (which is the insurance document presented by the broker) and who is 'denoted as the leader and is usually offered the business because of expertise in the class, which acknowledged by brokers and other underwriters.' (CII, 2010, p 9/3) The leading underwriter will also typically negotiate the terms and conditions with the broker. The following underwriters normally accept what has been negotiated by the lead underwriter and either participate in the risk (with a certain percentage) or decline.

It is also important to stress that the London market is still very much a face-to-face market place where brokers would present risk information directly to the underwriter (Lloyds, 2013); a fact also highlighted by Jarzabkowski et al (2010) who compared the business practices between reinsurers in Bermuda and Lloyd's of London. Both, Bermuda and Lloyd's of London write significant reinsurance business (A.M. Best, 2013); however, because of its geography the Bermudan market has developed a different business model. Jarzabkowski et al (2010, p 3) emphasise one of the main difference between Bermuda and Lloyd's of London is that in the latter market 'personal relationships are seen as crucial in volatile reinsurance markets, where trust and personal advocacy are important factors in expert judgement.' However, there is also the risk that because of the close relationships between brokers and underwriters both parties may feel obliged to accept deals which they would have been reluctant to do if it was not for this personal connection (Jarzabkowski et al, 2010).

In the context of aviation underwriting, Gardner (2013) highlights that there is reciprocity between brokers and underwriters when it comes to providing sufficient information to assess an aviation risk: 'Bottom line, if a broker breaches the trust of an underwriter, they could lose their appointment with that company [the insurer] as well as get involved in an Errors and Omissions law suit. Bottom line, if the underwriter continues to show a loss on his underwriting activities, they won't be around for long.' It can be assumed that the law suit refers to broker being sued by the client because of the refusal by the underwriter to pay the claim.

The Chartered Insurance Institute (CII) highlights that the 'core underwriting skill is the ability to determine the premium required to generate an underwriting profit to the insurer and writing

an exposure [...] that does not put the business at risk '(CII, 2010, p 9/8). However, this is a complex process and requires a significant amount of judgement. CII (2010) mentions a plethora of factors to be considered when making underwriting decisions thus illustrating the complexity of such a task which are shown in Table 3. This table is not an exhaustive list of underwriting considerations; however, it highlights that underwriting is more than just accepting or rejecting a risk. For example, an underwriter may also consider whether the risk presented fits into the risk appetite of the insurer or whether the capacity of the insurer for this type of risk has already been exceeded.

Table 3 Main underwriting considerations (Source: CII, 2010)

Main Underwriting Considerations
<ul style="list-style-type: none"> • The placing information, including but not limited to loss experience for the individual risk under consideration; • the insurance cover being requested; the geographic considerations; • characteristics of the risk (Le. those features which will help the underwriter determine whether this is a high, low or medium risk of its type); • any unacceptable aspects of the risk that cannot be reinsured; • exposure the underwriter already has on the class of business or in the area where the risk is located; • whether there is a formal rating scale for this class of business; whether there is an actuarial review available; • if exposure rating, what measure will be used - e.g. asset value, revenue, payroll; what price/rate is being suggested by the rating model; • any specific information supplied by a pre-risk survey; • whether the exclusion list is sufficient or should more exposure be excluded; whether there is any facultative reinsurance on offer and would the rate differ if the reinsurance was not taken up; • why the business is in London and whether London is the only market prepared to consider the risk; • whether a bank or other finance house is insisting on insurance being purchased - does this give an opportunity for a better than average price; • where is the market in the insurance cycle – [...]; • the premium being charged for similar risks; the underwriters of the original risk; • incurred loss ratios on other, similar risks, in recent years; the broking organisation placing the risk; and • any reasons why the future should be different from the past.

2.3.2 Underwriting Cycles

A description of the London Market would not be complete without mentioning underwriting cycles. Underwriting cycles are defined by Rubin (2000, p 436) as:

‘The tendency of property and liability insurance premiums, insurers’ profits and availability of coverage to rise and fall with some regularity over time. A cycle can be said to begin when insurers tighten their underwriting standards and sharply raise premiums after a period of severe underwriting losses. Stricter standards and higher premium rates often bring dramatic increases in profits, attracting more capital to the insurance industry and raising underwriting capacity. On the other hand, as insurers strive to write more premiums at higher levels of profitability (following a hard market), premium rates may be driven down and underwriting standards relaxed in the competition for business. Profits may erode and then turn into losses if more lax underwriting standards generate mounting claims. The stage would then be set for the cycle to begin again.’

Fitzpatrick (2004) rightly points out that all economies experience to some extent business cycles; however, underwriting cycles are not necessarily linked to the global economy and they appear to be more volatile than typical macro-economic cycles. For Atkins & Bates (2008) underwriting cycles are a function of demand and supply in the insurance market. Below are some of the drivers influencing supply and demand:

1. Underwriting cycles are a function of capacity as expressed by the amount of capital available to write business. When (re)insurers are loss-making then they will typically try to prune their portfolios in order to return to profitability which in turn reduces capacity in the market.
2. When interest rates are high, (re)insurers are able to earn significant investment income which could easily balance out underwriting losses. This applies in particular to insurers who write long-tail business, such as liability. In these classes of business, the final settlement of claims can take years from the first notification, but insurers will have to set up reserves which they estimate as the ultimate pay-out. For these reserves insurers will have to set aside assets which in turn will earn them investment income (Atkins and Bates, 2008). However, when interest rates are very low and insurers earn less investment income, underwriting results become more important which reduces the capacity in the market. As a result, insurers will be forced to improve underwriting margins in order to compensate for declining investment returns.
3. One of the main factors, influencing underwriting capacity is the occurrence of 'capital shocks' (Harrington & Niehaus, 2000, p 657) such as catastrophic events like Hurricane Katrina where (re)insurers are incurring huge losses thus diminishing capital and consequently reducing underwriting capacity.
4. Reinsurance capacity is also impacting underwriting capacity in the primary insurance market, albeit to a lesser extent than the above mentioned factor. Primary insurers are dependent of being able to cede risks to reinsurers. If reinsurers decide (because of the above mentioned issues) to increase prices or reduce capacity then primary insurers will have to consider whether to write certain risks in light of increased prices or reduce reinsurance capacity.

The various stages of an underwriting cycle are illustrated in Figure 3 below. The purple line (left-hand scale) shows the percentage of underwriting profits or losses expressed as a percentage of

net earned premiums (NPE). ² The green line (left-hand scale) shows the percentage of pre-tax operating income as a percentage of NPE. The purple line highlights the cyclicity of underwriting results which have been mostly negative since 1969. However, pre-tax operating income takes into account regular investment income (without capital gains) and the graph highlights that U.S. Property/Casualty insurers produced overall profits despite making underwriting losses. The red columns demonstrate the contribution of catastrophe losses (e.g. Hurricane Katrina in 2005) to the underwriting performance.

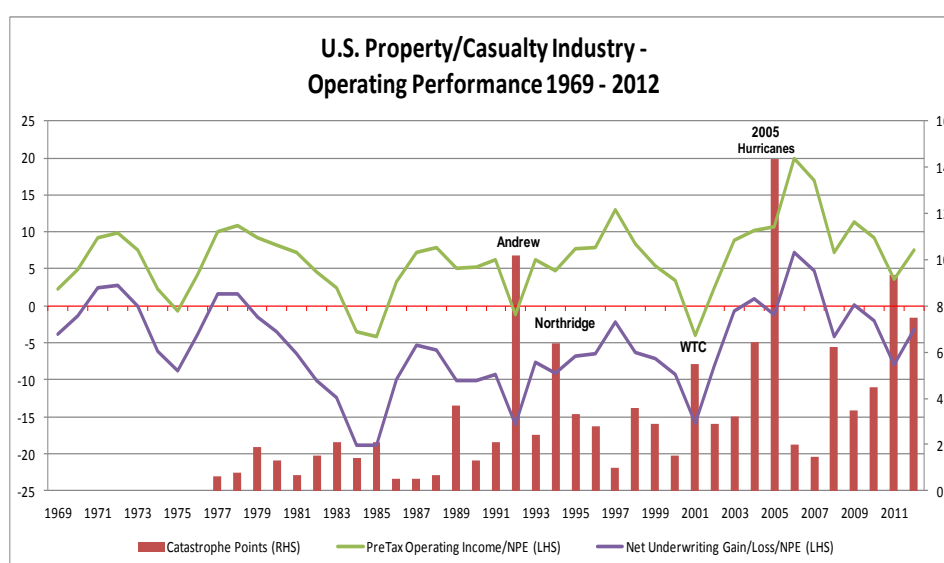


Figure 3 US Property/Casualty Financial Performance (Source: A.M. Best, 2013 b)

Fitzpatrick (2004) argues that these more economical or rational arguments about underwriting cycles miss other important factors or the roots of these phenomena which could be as much behaviourally as economically driven. Stewart (1984) notes that ‘insurance supply is as psychological as it is financial’ (cited by Fitzpatrick, 2004). Feldblum (2001) challenges the assumption of psychological influences because underwriting cycles are driven by the whole market rather individual underwriters and it would be odd to presume that all market participants are driven by behavioural factors. However, Fitzpatrick (2004) believes that while economic explanations of underwriting cycles help to understand this phenomenon, they may fall short of explaining other causes of these cycles, in particular the fact that there is not necessarily a herd mentality. Market players view the state of the underwriting cycle from their

² Net earned premiums: Insurance premiums earned during a financial year after deducting reinsurance premiums

own individual position or circumstance. For example, an insurer who is exposed to asbestos related liability claims will have a different view of the state of market than an insurer who has not been forced to increase claims reserves because of higher number of reported claims and higher court awards. Weiss (2007, p 32) also argues that ‘the regularity of underwriting cycles may call into question the rationality of insurance market operations.’

Fitzpatrick (2004) also points out that the management of insurers, but also underwriters, will have growth ambitions as this ensures viability and thus employment. A factor for bonus compensation is also often premium growth even if long-term incentives might be based on the overall profitability of the portfolio. In addition, the structure in the employment market, which applies in particular to the London Market, makes it easy to switch from one insurer to another. Insurers very often poach underwriters from competitors, if they want to expand in certain lines of business. However, there is obviously an expectation that these underwriters are able to bring in new business. This is easier in long-tail business where it can take years until the final claims experience picture emerges. This means that underwriters are able to grow a liability portfolio relatively quickly by undercutting prices. So for a number of years, the growing portfolio might look relatively profitable, but by the time claims start being reported the underwriter may have already moved to another insurer in the market. This phenomenon is cynically described as ‘write and run’ behaviour (Fitzpatrick, 2004, p 266).

Fitzpatrick (2004) also argues that insurance brokers have a large influence in respect of the formation of the underwriting cycle as they represent the interest of insurance buyer thus have to try to obtain the ‘best deal’ (Fitzpatrick, 2004, p 269) from insurers. There is natural conflict of interest between underwriter and broker as the latter do not want to lose the client to another broker who can offer insurance for a cheaper price. Underwriters do not want to lose the business to another insurer and have therefore to be flexible when it comes to pricing which in turn could increase pricing hikes when the real costs are revealed at a later stage.

The *winner’s curse* is a phenomenon in economic theory which tries to explain the behaviour of bidders in an auction (Thaler, 1988). Bidders will often pay a too high price for the underlying asset in order to get hold of the good. Fitzpatrick (2004) and Cummins and Doherty (2006) see this theory as relevant for the insurance market; however, view the relevance from different angles. The former considers that underwriting behaviour is very often driven by the wish to generate new business and hence underwriters would charge an insufficient price because of an over-optimistic assessment of the risk. The latter regards the underwriter’s behaviour after realising that undercutting prices led to losses. Cummins and Doherty (2006) argue that as a

consequence of this bad experience underwriter would be more conservative in their behaviour by either decline the risk or quote a non-competitive price. Both arguments are not wrong and both types of behaviour can be found in the London market. However, this will very much depend on the state of the underwriting cycle. Where prices are under pressure (soft market) underwriters who are keen to get new business are likely to have a more optimistic view of the risk, consequently underpricing it, whereas in a hard market it is easier to have taken a more conservative pricing stance due to the scarcity of capacity.

Weiss (2007, p 42) concludes that 'the disparate underwriting cycle theories [...] may leave one with same feeling obtained by looking at a tangled ball of twine. How can these theories be disentangled to determine how much each of them contributes to underwriting cycles, if they contribute at all? [...]. Undoubtedly, questions such as these are the next frontier in underwriting cycle research.'

2.4 Information asymmetry

Zweifel and Essen (2012) claim that insurance companies are generally faced with an asymmetry of information as the policyholder and/or the broker know more about the risk to be insured than the insurer. This problem arises when either the buyer or seller is privy to information which the other party does not have (Skipper and Kwon, 2007). Zweifel and Essen (2012) identify four main problems with this asymmetry:

1. **The lemons problem:** In line with the description of Akerlof (1970) of the behaviour of used car sellers in the US who try to sell a so-called lemon to a potential buyer who is unaware of the faults of the car. Because of information asymmetry there is no differentiation in the price of a bad car (lemon) and a good car as the buyer cannot see the difference when he/she purchases the car (although it will become apparent at a later stage).

Applying this principle to insurance, Akerlof (1970) uses the example of health insurance whereby elderly people seek insurance cover because they know that they will claim more frequently than younger people. It could be argued that insurers would be aware of this fact; however, Akerlof (1970) points out that whilst insurers will adjust their premiums to reflect the age of the insured, only the most pessimistic insured are likely

to take up insurance because they have an information advantage over the insurer. For all others, the premiums charged by the insurer are prohibitive because they cannot see the point of buying insurance for a relatively high premium. As a consequence insurers may have deal with a higher number of claims than expected.

2. **A principal agent problem:** This problem emerges when the buyer of a product or service (principal) is not fully informed about the agent's action. For example, a broker may recommend a specific insurer because he/she can earn a higher commission.
3. **Adverse selection:** In insurance markets 'adverse selection results from the asymmetric information between the insured (agent) and the insurer (principal).' (Dionne and Doherty, 1991, p 98). Insurers typically calculate an average premium for a pool of risks based on the risk profile of the insureds. However, more high-risk individuals are likely to seek insurance than low risk individuals without divulging full information to the insurer. For example, smokers may underplay their smoking habits when it comes to health insurance and the insurer may not be able to verify these habits, thus underestimating the expected value of claims in a pool of risks.

Adverse selection can also occur after the commencement of insurance cover when profitable policyholders leave the pool of risk thus increasing the probability of claims. For example, a property insurer may have started with a diversified portfolio of risks, but has lost the low risks to competitors who offered better prices. This insurer is then left with unprofitable risks. In the long run this can lead to insolvency (Zweifel and Eisen, 2012).

4. **Moral hazard:** This is concerned with the behaviour of policyholder once they have concluded an insurance contract. For example, policyholders become less careful when they know that there is insurance cover in place and are less keen to maintain sprinkler systems or theft alarms (Skipper and Kwon, 2007). This forces insurers to increase premiums to take this behaviour into account and can result in a higher number of claims and higher claims pay-out (Zweifel and Eisen, 2012). Koch et al (2009) go further and argue that there is a general attitude of policyholders to get their money back (i.e. premiums) because the payment of insurance premiums is not seen as not really seen as a fair price in return for insurance protection. This attitude may have to do with

perceived anonymity of insurance companies which means that there is a limited risk of repercussions by the insurer when policyholders notify insurers of fraudulent claims.

In all these four cases reputation might be relevant. Reputation potentially provides information to market participants as to the likely behaviours of the parties involved. In the context of moral hazards, Koch et al (2009) argue that a holistic understanding of behavioural patterns of policyholders once they have insurance cover can help to better understand these moral hazards. Koch et al (2009) also point out that human beings are normally encouraged to display cooperative behaviour (or reciprocity) in smaller groups because there would be sanction mechanism in place if group members behave opportunistically. These group members would quickly get a reputation for not behaving in the interest of the group. However, in the anonymity of a large pool of policyholders this sanction mechanism does not work.

However, it should be noted that information asymmetry is not limited to insurers. Policyholders are also faced with information asymmetry which according to Baltensperger et al (2007, p 12) has to do with 'the "inversion of the production cycle" in the insurance industry, i.e. the fact that insurance services are only produced and delivered after they are purchased and paid for by policyholders, in many cases years later only. This creates the difficult problem for policyholders to monitor the financial condition and solvency of their companies over extended periods of time.' Consequently, this leads to severe information asymmetries between the consumer and the insurer (Baltensperger et al, 2007). Yang (2013) agrees with this by highlighting that there is a general assumption that only insurers are affected by information asymmetry. Insurers can have an information advantage towards policyholders as insurers are more familiar with the interpretation of the terms and conditions they offer. Charles River Associates (2011) highlight another potential information asymmetry, namely between the insurance customer and broker. Here the broker has better information about insurance markets and what insurance cover is available, which is actually the reason why customers use brokers. However, there is also potential information asymmetry about the financial condition of the broker and behavioural aspects when it comes to dealing with claims and dealing with client money.

Nerd (2002) argues that information asymmetries exist where there is incomplete information about the transaction partner and introduces three main types of this incomplete information:

1) Hidden characteristics: Uncertainty about the characteristics of the transaction partner or the products/services offered or the quality of the product:

2) Hidden intentions: the risk of opportunistic behaviour especially where one transaction partner has to take the first move (e.g. insurance) and has to wait for the fulfilment of the obligation of the other:

3) Hidden actions: where one partner is unreliable or whether there is a risk that one contractual partner is not sticking to the promises he/she made or where the quality of a product is not as good as it was advertised.

2.5 The role of intermediation in the insurance buying process

Insurance products can be sold through a wide range of distribution channels, including brokers, company agents and through direct sales channels. The majority of personal lines insurance is either sold directly (e.g. Direct Lines Insurance) or through price comparison websites (which are included in the broker column in Figure 4). The preferred sales channel for commercial insurance is still brokers (or intermediaries), despite a decline in recent years.

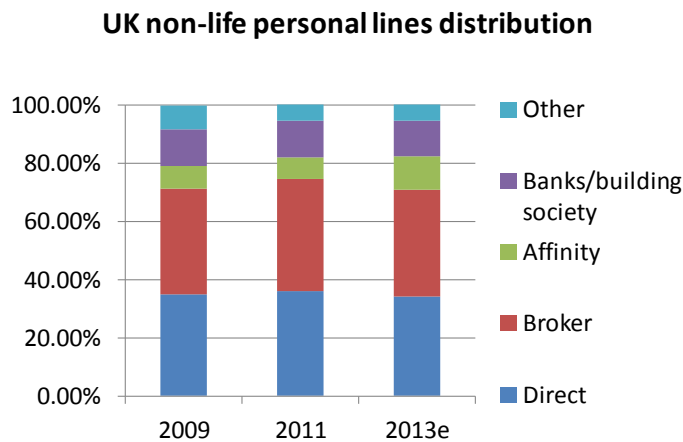


Figure 4 UK personal lines distribution (Source: Datamonitor, 2012)

UK Commercial Insurance Distribution

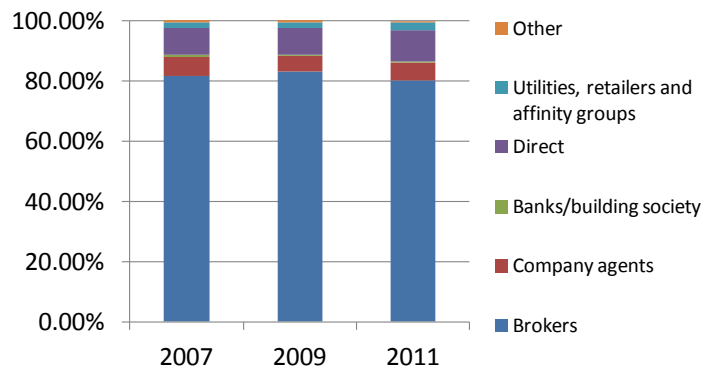


Figure 5 Commercial insurance distribution (Source: Datamonitor, 2013)

Brokers play an even more important role in the London insurance market and majority of business at Lloyd's of London is placed through brokers (TheCityUK, 2011). They are a key part of the London market as they bring the risks to be insured to the underwriters. However, this distribution channel is dominated by three big global broker houses, Marsh McLennan, AON and Willis where the majority of business is sourced from (TheCityUK, 2011). Table 4 shows the 10 largest insurance brokers based on their world-wide revenues and most of the brokers mentioned will have operations in the London market.

Table 4 Largest global Insurance brokers (Source: A.M. Best, 2013 b)

10 Largest Global Insurance Brokers		
Position	Broker	Brokerage revenue 2012 (\$bn)
1	Marsh & McLennan	11.9
2	Aon Corp	11.5
3	Willis Group	3.5
4	Arthur J. Gallagher	2.5
5	Wells Fargo	1.9
6	BB&T Insurance Services	1.6
7	Jardine Lloyd Thompson	1.4
8	Brown & Brown Inc	1.2
9	National Financial Partners	1.1
10	Lockton	1.0

The legal name of placing insurance business is “insurance mediation” which is defined by the Insurance Mediation Directive of the European Union (IMD 2002, Article 2 No 3) as ‘the activities

of introducing, proposing or carrying out other work preparatory to the conclusion of contracts of insurance, or of concluding such contracts, or of assisting in the administration and performance of such contracts, in particular in the event of a claim.’ From this follows that ‘any natural or legal person who, for remuneration, takes up or pursues insurance mediation’ shall be deemed an insurance intermediary for the purpose of this directive. (IMD 2002, Article 2 No 5) For Flesch (1998, p 29) the more legal definition of ‘intermediary’ rather than broker suggest that a broker is really “the piggy in the middle” and is ‘thereby under pressure from both other parties involved.’ These parties are the policyholder and the insurer.

Lloyd’s of London Intermediaries

Lloyd's underwriters do not generally deal directly with policyholders. Instead, business is normally accepted through intermediaries (Lloyd’s brokers) that have been accredited (by Lloyd’s) to broke insurance business at Lloyd's. Accredited Lloyd's brokers place risks in the Lloyd's market on behalf of clients. ‘These brokers use their specialist knowledge to negotiate competitive terms and conditions for clients. Currently there are over 180 firms of brokers working at Lloyd's, many of whom specialise in particular risk categories. Each broker is required to demonstrate an understanding of the Lloyd's market, as part of Lloyd's assessment of its suitability to be accredited as a Lloyd's broker. All brokers must satisfy all relevant regulatory requirements. Lloyd's performs a careful assessment of all applicant brokers, affirming their reputation and financial standing and investigating the character and suitability of officers and employees before making the decision to accredit.’ (Lloyd’s of London, 2013)

Flesh (1998) argues that one of the advantages of engaging brokers is that they can be hold responsible if they fail in doing a proper job. Insurers are also interested in getting good business (i.e. an insurance portfolio) from brokers. Flesh (1998) believes that are four main characteristics of good business:

- Risks where the premium is not negotiated down to the lowest offer in the market, i.e. where the insurer has a chance to make a profit
- Policy with normal conditions, i.e. without special conditions where pricing becomes difficult and where the risk becomes more complex
- A broker who is competent and who pays the premiums due promptly
- A broker account which overall is profitable with a reasonable spread of risks.

Flesh (1998) also points out that one way of getting business from a new client is through reputation or through specialisation.

In principle, a broker is normally asked by a (corporate) client to place a risk with an insurer or with a number of insurers, for example a new plant construction in India. The broker will then prepare a submission based on the information provided by the client. Thoyts (2010, p 137) summarises the next steps a broker has to take: 'The broker's job is then to enter the market and find a lead for the risk, an underwriter who will accept the risk and set the rate of premium and terms.' However, it is not only important to find 'a' lead, but also to 'find the right lead, an underwriter whose expertise in the type of risk is recognised. If the lead underwriter's judgement is trusted, the market will happily follow.' (Thoyts, 2010, p 138) Once the broker found a lead underwriter who is willing to underwrite the risk, the underwriter will also indicate what percentage of the risk he/she is willing to take. The broker -on behalf of the client- can then either accept or reject the offer.

If the broker accepts the offer from the lead underwriter (after consulting with the client) the broker tries to place 100% in the market, based on the terms and conditions agreed with the lead underwriter. If the lead underwriter has taken a percentage of the risk which exceed the company's/Syndicate's own limit then reinsurance has to be arranged unless an automatic treaty for this kind of risk is already in place. This is very often the case for standard risks where reinsurers automatically provide capacity when the risk is placed. For special risks facultative arrangements are very often necessary (CII, 2010).

Factors influencing the choice of brokers by corporate buyers

Standard & Poor's, the US rating agency, conducted a survey amongst European corporate insurance buyers on how they select and evaluate insurance brokers (S&P, 2011 a). Some of the 108 participants in this study are likely to insure their businesses in the London market. The survey participants were asked to rank 11 attributes of performance. These attributes and the average importance scores are shown in Figure 6:

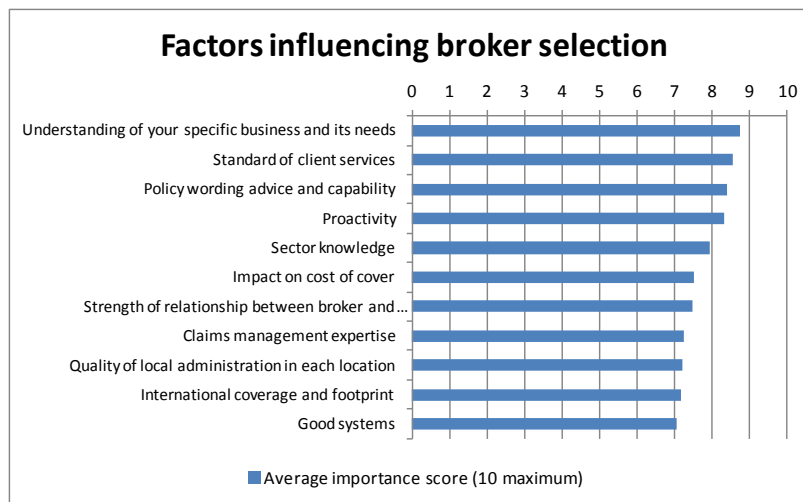


Figure 6 Factors influencing broker selection (Source: S&P, 2011 a)

The S&P report also published some of the findings from individual interviews and highlighted that one of the main differentiation factor for a broker is a better understanding of the insured's business and the strength of the relationship with the broker by quoting one of participants: *"the main broker goes the extra mile, you can call them at 5.30 on a Friday."*

The interviews with corporate insurance buyers also covered what would cause them to change brokers. The S&P report pointed out that the issues most mentioned were a 'problem or reduction in the level of client service or speed of response provided.' (S&P, 2011 a, p 17) More importantly, the report also mentioned that 'a breakdown of trust, perceived loyalty of the broker, and concerns about transparency' (S&P, 2011 a, p 17) were frequently mentioned. Quotes from individuals illustrate some of issues for corporate insurance buyers: *"if they get too cocksure/negligent/don't manage the relationship and service...this has happened with some brokers."* *"rapid turnover of staff, lack of continuity, laziness, dishonesty, bluffing."* (p17)

Although the strength of relationships is only the 7th most important factor for insurance buyer, the quotes from individual interviews show that insurance buyers have certain expectations in terms of how broker built up relationships, trust and provide service.

2.6 The insurance purchase process of corporate buyers

Corporate buying of goods or services differs from consumer purchasing due to the different markets, but also due to others factors influencing organisational behaviour. Evans et al (2009) argue that the decision making process involve a degree of rationality, but there is also a higher perception of risk assumed. Webster and Wind (1972) identified four factors which influence corporate buying decision namely environmental forces, organisational group factors and individual forces:

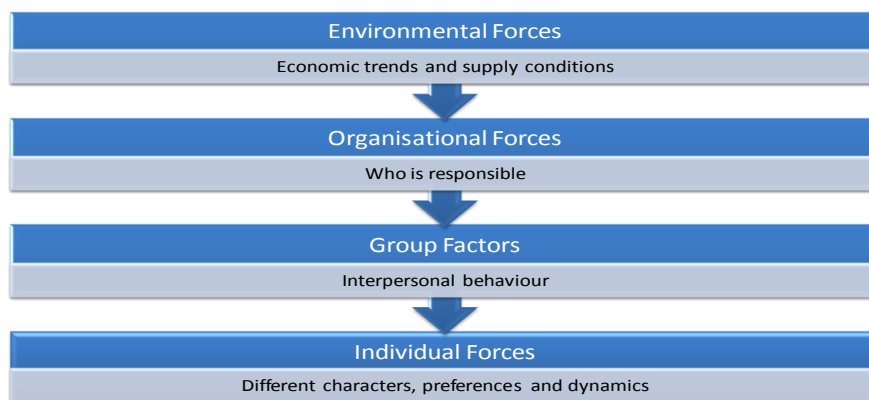


Figure 7 Factors influencing corporate buying behaviour (based on Webster and Wind 1972)

In principle, the decision to purchase insurance follows a similar process as for other goods and services. However, the motivation why corporations buy insurance is still debated. For example, Mayers and Smith (1982, p 281) argue that ‘although risk aversion is unquestionably at the heart of demand for insurance by individuals, it provides an unsatisfactory basis for analysing the demand for insurance by corporations.’ It should be seen more as financing decision. However, this only applies to larger (listed) companies and not to smaller or family owned firms because their livelihood might be endangered if there is no insurance place. Mayers and Smith (1982) conclude that motives for buying insurance are mainly driven by:

- Risk allocation to other firms who have experience in risk bearing,
- Lower transaction costs
- Claims administration services

Especially claims services which Myers and Smith (1982, p 281) consider as ‘real services efficiencies’ drive insurance demand and replaces risk aversion as the main motivation because insurer are generally better in dealing with claims because of their expertise and economies of scales.

Skogh (1989) also point out that the transaction cost theory can be applied to explain demand for corporate insurance. Although Skogh (1989) accepts that the pooling of risks concept drives demand, it cannot fully explain the purchase of insurance. For example, if shipping traders would not agree to buy insurance they would have to draw up terms and conditions to deal with damages and other issues. Hence, an insurance policy can reduce transaction costs. Main (2000) also sees transaction costs as a rationale for insurance buying arguing that the external monitoring role of the insurance underwriter inhibits opportunistic behaviour by the firm thus improving co-operation amongst stakeholders.

A point in case for this argument may be BP which relies heavily on self-insurance and only buys limited protection in the insurance market. It could be argued that if there had been a stronger monitoring by insurance companies, the losses from the explosion of the Horizon oil rig would have been less severe (BP, 2013 and Lowe et al, 2010). Hoyt and Kang (2000) go further by suggesting that one of the rationales to buy insurance is to minimise agency problems between the managers and the owners of a firm. Hoyt and Kang (2000) also see a social role in insurance rather than a pure risk transfer function. However, these arguments ignore that some insurance are compulsory (such as motor insurance and employers' liability insurance) where other factors will influence the choice for an insurer.

The arguments above assume by and large a rational behaviour of insurance buyers. However, when buying insurance individual or groups make decisions about the level of risks they wish to retain or to transfer to a third party (insurer). Insofar, they will not necessarily follow rational arguments and Mueller-Reichert (1995) argues that insurance decisions should be considered in the context of the findings of behavioural science relating to decision making under uncertainty. Mueller-Reichert (1995) further points out that as part of an insurer's risk management strategy it would be helpful to understand why policyholders made certain decisions in respect of risk transfer. This might also provide clues why some policyholders are more loss prone than others.

Hun Seog (2006) adds a different angle to the above argument by highlighting that if corporates buy higher level of insurance they might behave more aggressively (for example in terms of quality control) due to perception of limited liability. For example, these insurance buyers may relax risk management standards as in light of insurance cover available they think they can do away with these standards. This argument is similar to the moral hazard issue discussed in Section 2.4. Muller-Reichert (1995) offers a schematic model in respect of the insurance or risk decision process (Figure 8):

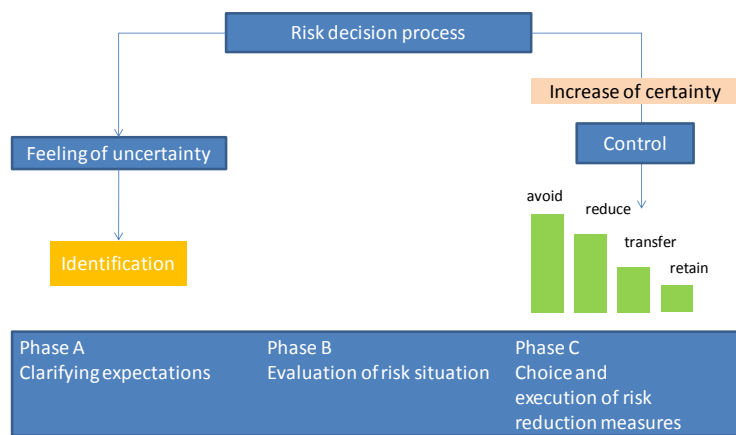


Figure 8 Risk decision process (based on Mueller-Reichart, 1995)

Corporate buyers' evaluation criteria for insurance selection - Standard & Poor's survey

In January 2011, Standard & Poor's, published the result of survey amongst European corporate insurance buyers. The objective of the survey was to identify how corporate insurance buyers evaluate insurers and what factors influence the selection. The survey was conducted amongst senior risk managers and insurance managers from corporate, such as Unilever or DHL. Given their insurance needs they are likely to place business in the London Market.

Whilst this survey does not explicitly deal with what influences reputation, the factors mentioned in the survey are clearly factors which impact reputation. The report list 10 most important factors for choosing an insurer:

1. Financial strength
2. Willingness to pay
3. Completeness of cover
4. Understanding your specific business and its needs
5. Insurer rating
6. Flexibility of approach
7. Technical expertise
8. Extent of international footprint/network
9. Headline price
10. Capacity

Financial strength and insurer rating are somewhat related as they refer to the capital strength of an insurer, although rating agencies take other factors into account when assigning a financial strength rating, such as business position or financial leverage (S&P, 2014). However, interviewees also associated insurer ratings with available financial information and analysis about an insurer. Completeness of cover refers to the wish of corporate insurance buyers to get the insurance cover they aspire to have and does not necessarily mean they get as much comprehensive cover as possible.

The factor ‘understanding your specific business and its needs’ is seen as something which it can only be built through a long-term relationship and which sometimes can provide a competitive advantage if insurers have made an effort to fully understand the corporate buyers’ needs.

Flexibility of approach refers to the behaviour of insurers, for example in terms of servicing the client, providing extension of cover and pricing structure. Technical expertise refers to the technical knowledge of underwriters which should enable them to correctly evaluate and price the risk and international network is important for global corporates who need to deal with world-wide insurance needs for their subsidiaries. The willingness to pay refers to insurers’ behaviour when dealing with a claim.

Figure 9 shows the proportion of respondents who scored 9 or 10 (highest scores) for the above mentioned factors:

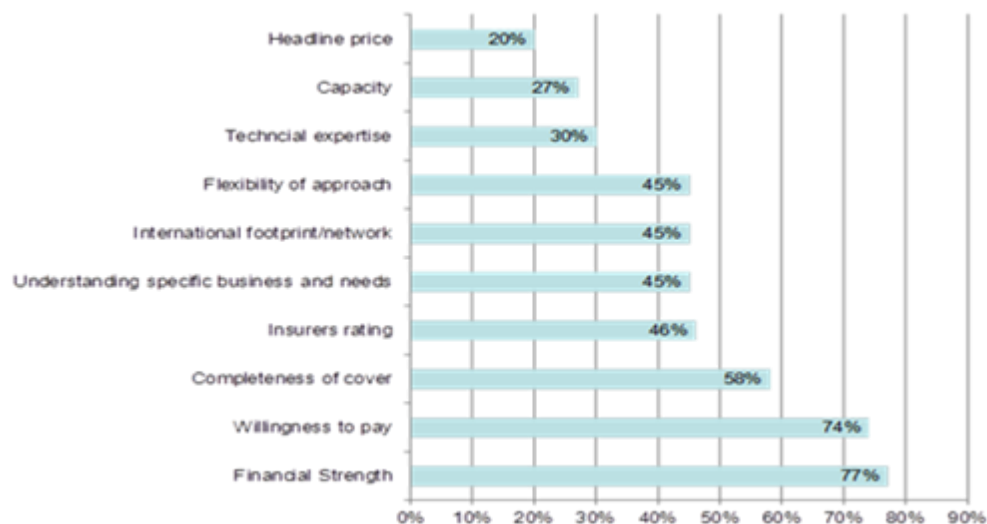


Figure 9 Determining factors for insurance buying (S&P, 2011 b)

The report concludes that: 'Currently these professionals have to deal with considerable uncertainty when choosing or retaining insurers, particularly with regard to factors such as willingness to pay and servicing capabilities, which often remain opaque until cover is in place or a major claim is made. This lack of transparency arguably undermines the efficiency of the insurance market.' (S&P, 2011 b, p 5) Another central message from the S&P (2011 b) report is that corporate buyers appreciate a long-term relationship with the lead insurer; a factor which contributes to the understanding of business needs by insurers and which also can help to provide a competitive advantage if taken seriously.

2.7 The Placing Process in the London Market

'We Germans use technical rates. In London they use ceiling rates. The underwriter reads the slip, looks at the ceiling, and puts down the first number which comes into his head.'

(German underwriter quoted by Woodthorpe –Brown (2010))

This slightly ironic quote by Woodthorpe-Brown (2010) highlights some of the difference between the London insurance market and other insurance market, but also provides an insight into the variety of risks underwriters get to see in the London insurance market.

As pointed out in Section 2.3.1, the London Market is a subscription market which means that brokers typically negotiate with a lead underwriter the terms and conditions of the insurance contract and follow underwriters join the lead with a percentage of the risk they wish to accept.

The placing process can roughly split into four main stages:

1. Client instruction
2. Quotation by Underwriters
3. Formal placement process
4. Policy documentation

Client instruction: The placing process starts with a broker (or in some cases a number of brokers) being instructed by the client to find insurance cover for a certain risk. In order to assess the client's requirements, the broker should gather sufficient information from the client about the risk to be insured (CII, 2010). If it is an existing risk then the loss history is also important.

The broker has also duty to remind the client of its obligation to disclose all material facts (see section 2.11). Once the broker has gathered all the necessary information, the broker usually produces a submission document which enables underwriters to assess whether they can write the risk, what premiums should be charged and what terms and conditions would be applied (CII, 2010). Based on the Insurance Conduct of Business Rules (ICOBS 5.3) of the Financial Conduct Authority (FCA), the broker must provide a 'fair analysis' of the insurance market where the broker seeks to place the business (e.g. The London Market). CII (2012, p 5) offers three stages of the above mentioned fair analysis to be carried out by brokers:

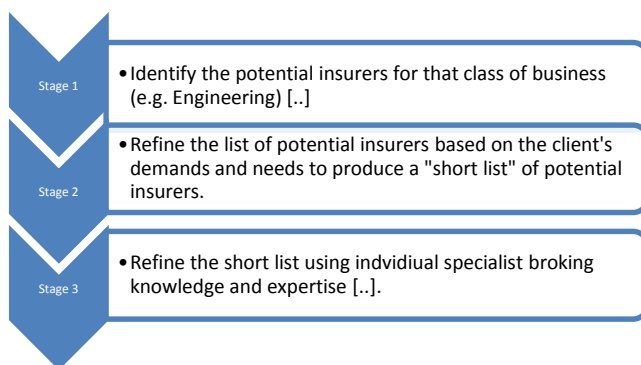


Figure 10 Fair analysis stages (Source: CII, 2012)

Quotation by Underwriters: Once a shortlist has been drawn up, the broker will either approach only one underwriter or a number of underwriters to obtain a quotation for the risk to be insured. It should be noted that at the initial stage the broker will only approach potential leaders who are able 'set good terms and conditions for the client; and be credible to other insurers so that the following market will support the leader, should the leader decide not to take 100% of the risk'. (CII, 2013, p 7/6) In *American Airlines Inc v. Hope* [1974] 2 Lloyd's Rep 301 Lord Diplock highlights the reputational aspect of finding a lead underwriter: '[...] He (the broker) takes the slip in the first instance to an underwriter, i.e. one who has a reputation in the market as an expert in the kind of cover required and whose lead is likely to be followed by other insurers in the market'. Kumbunlue (2005, p 75) adds that 'a leading underwriter is the underwriter who the broker believes would subscribe to the risk with a reasonable amount of share and whose judgement is trusted by the following underwriters. Have a reputable leading underwriter initial the slip makes the risk attractive to the following underwriters.'

Apart from a reputation for being a lead underwriter, the broker's choice of underwriters will depend on a number of additional criteria which are highlighted in Table 5:

Table 5 Broker criteria for selection insurers (Source: CII, 2012)

Criteria	Description
Service to clients	For any business, the quality of service provided is vital. The broker needs confidence that, for example, claims notified direct are dealt with expeditiously.
Service to broker	The broker needs a fast response to quotation requests, prompt issue of renewal terms, claims experience and all relevant documentation.
Underwriting appetite and specialist areas	Some carriers are only interested in 'plain vanilla' risks, whereas others are more adventurous.
Breadth of cover	This is obviously important for individual client needs, but the broker also needs an across-the-board flexibility, especially in the area of agreed wordings and the speed at which negotiations are conducted.
Innovation	Innovation is an overdone expression in insurance. What a broker needs is an insurer that is willing to think differently to help solve client problems. The most common example is being willing to quote non-conventionally, that is a self-insured programme as opposed to conventional guaranteed cost.
Credit facilities Capacity	An obvious benefit, depending of course upon the conditions. Capacity needs to be adequate for the majority of clients. It is obviously driven by the scale and nature of the risk.
Geographical spread and quality of global organisation and administration	A necessary requirement for global business.
Technical advice and specialist expertise	In theory, all insurers should be able to provide technical advice in respect of their own policies. Yet in many insurers, technical specialists remain locked away, inaccessible to brokers. Thus the insurer who is willing to support the broker's technical service to clients gives a competitive advantage.
Competitiveness	The insurer does not need to have to be competitive on every risk, provided it can give support when needed.
Reputation	Quality of reputation is a general attribute for any business. One aspect of interest to brokers and their clients is performance in relation to the Financial Ombudsman.
Financial Security	The financial security of an insurer, and hence its ability to meet claims, is obviously important and should be a major factor in the broker's selection process.
Continuity	Obviously this is important at an individual client level. The broker also needs continuity when there is an individual client-based problem, for example an unexpected run of bad claims where the insurer takes a broad view in the context of the overall relationship.
Access to decision makers	In many published surveys of brokers concerning insurer service, often one of the key criteria selected by brokers is access to people who know what they are doing and can make decisions. This does not mean access to the top, the broker just needs to talk to someone who understands the problem and can resolve it, and is able to do so quickly, in a way that makes sense.
Relationship management and attitude of the insurer to the broker	Most insurers employ field staff to manage relationships with brokers. The broker needs to know that these individuals have the support of their management and the necessary resource to support the broker in developing business overall and with the insurer. Many large insurers have marginalised smaller brokers. This naturally causes smaller brokers to work harder with other insurers that support them and to work reluctantly with larger insurers as a 'necessary evil'.

The broker will usually prepare a submission document which used to be called a slip, but which has now been replaced by a Market Reform Contract (MRC). The MRC is a standardised document which summarises the risk the client wishes to insure and which will be presented to the underwriters. The underwriters evaluate the risk based on the information provided and indicate the premium rates to be charged and the lines they would be willing to write. A sample of an MRC is shown in Appendix A which highlights the information necessary to assess the risk, but also to finalise the policy document.

Formal placement process: Once the broker has obtained the quotations from the underwriters (if provided), the broker will discuss these quotations with the client, including the pros and cons of each quotation. The client will consider the quotations and select the preferred option after which the broker will start the 'formal placement process' (CII, 2013, p 8/3). The broker will then seek to fully place the business in the market with follow underwriters (as the chosen lead underwriter is bound by the quotation provided). Each underwriter 'indicates its agreement to taking the share using a rubber stamp' (CII, 2013, p 8/3) (see sample in Figure 11)

Once the underwriters have agreed their written line they are on risk at the inception of the policy stated in the MRC. However, there may be cases where the risk has been oversubscribed which means that the total of written lines exceeds 100%, in which case each written line will be 'signed down' in order to reach a 100% share of the risk to be underwritten. (CII, 2013, p 8/4).

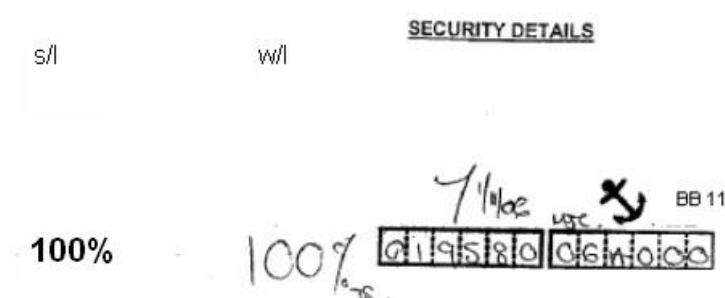


Figure 11 Sample of underwriter's signed line (Source: London Market Group, 2012)

Policy documentation: Once insurance cover has been obtained, the broker will confirm insurance to the client. Under the Contract Certainty Code of Practice (ABI et al, 2012), insurers have to provide a full contract documentation promptly (which is deemed to be within 30 days for commercial clients) to the insured. This is normally the insurance policy, but can also be a copy of the MRC.

The London Market Group (LMG) has produced a flow chart which summarises the placing process in the London Market, but also highlights the complexity of placing business in the London Market.

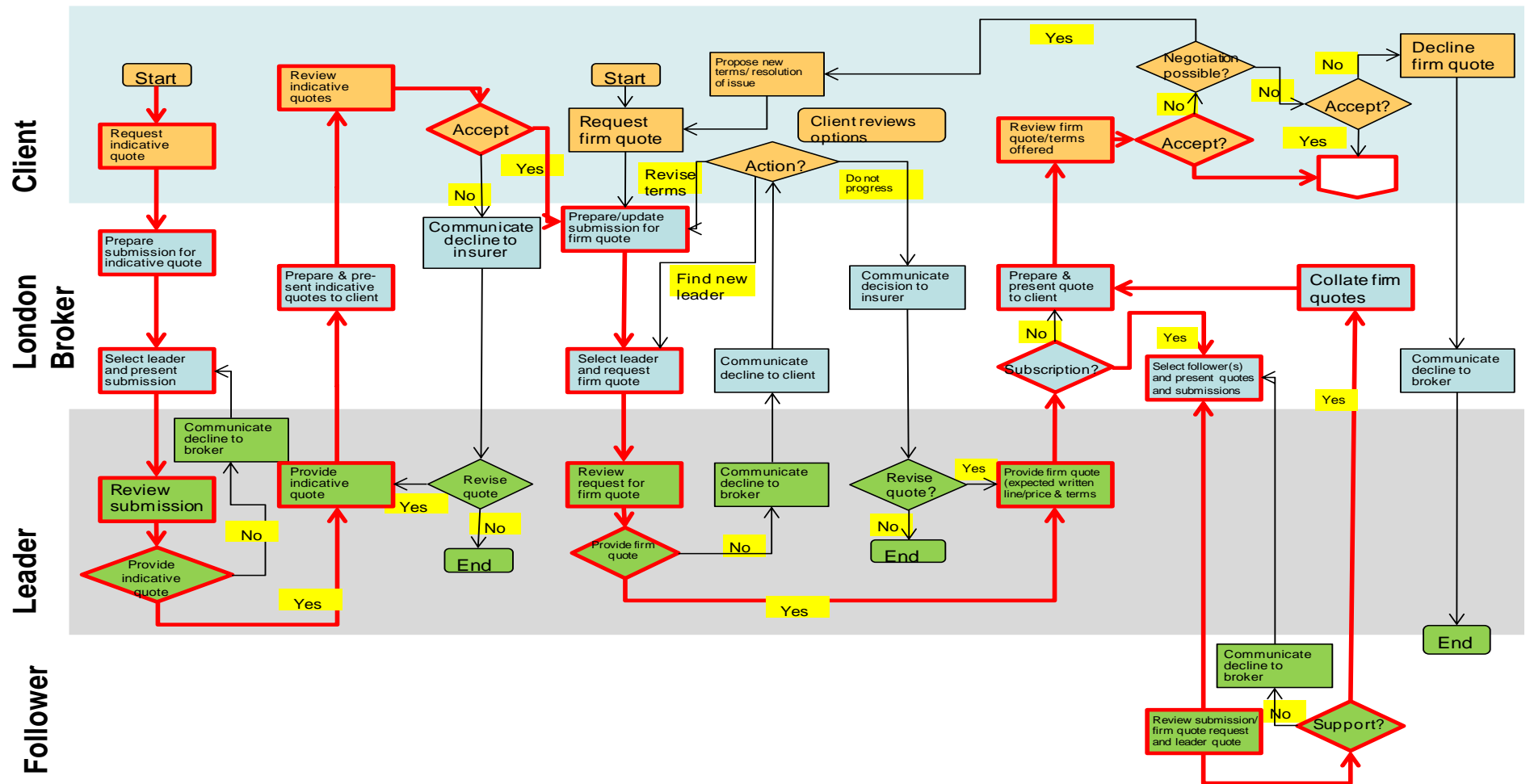


Figure 12 Flow chart placing process (based on LMG, 2010)

2.8 Electronic trading

Following from the steps taken to improve contract certainty in 2004 (see Section 2.13), the Marketreform group (now London Market Group), which consists of all participants in the London Market, was charged with modernising the practices in the London Market with a view of implementing electronic processes without hampering the key strengths of this market place, in particular the face-to-face negotiations between the underwriter and the broker (LMG, 2010). Woodthorpe-Browne (2010, p 14) accepts that there will be an increase in electronic trading, but not for complex risks because ‘the market works by brokers being able to talk to underwriters face to face, and establish relationships of trust with them.’

The London Market Group highlights the reasons for the modernisation of processes in the London Market:

‘Since its formation, the London insurance market has been reliant on manual processes and hard-copy documentation for the transaction of business between broker and underwriter. The associated inefficiency; the high cost of handling paper, the lack of control, the lack of immediate availability of records and the delays in serial distribution of paper - with the associated negative impact on customer service and competitiveness - have led market organisations to implement electronic processes to support the placement and amendment of insurance business.’ (LMG, 2014)

Below are the four main strands of electronic processes initiatives (Lloyd’s Market Association, 2014):

- [E-Accounts](#) – the development and adoption by brokers of ACORD³ data messaging for the submission of premium transactions to Xchanging.
- [Support for placing](#) – the development and implementation of electronic processes and associated protocols to provide support to the placement of business including endorsements and binder declarations.
- [ECF](#)⁴ – the initiative to migrate Lloyd's market claims handling from paper to electronic processes and, ultimately, to provide a quicker claims service to policyholders.
- [The Exchange](#) – a hub to enable brokers, underwriters and IT suppliers to have a single connection for the exchange of ACORD standard data messages.

³ ACORD: Association for Cooperative Operations Research and Development

⁴ ECF: Electronic Claims File

Figure 13 shows the anticipated future infrastructure landscape for the London insurance market:

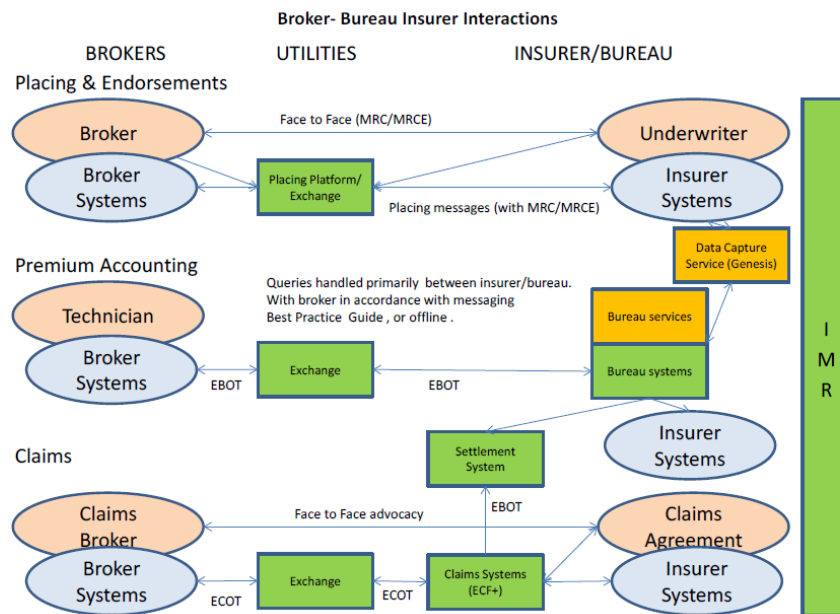


Figure 13 Future infrastructure landscape (Source: LMG, 2013)

The Broker Clinic, an event organised by Insurance Times and held in April 2013, discussed how insurance brokers view e-trading for complex risks and there appeared to be a consensus amongst delegates that complex risks need to be treated differently from more straightforward commercial risks. It is about maintaining the relationship with underwriters. Insurance Times (2013, p 16) concluded that ‘using existing methods [i.e. automatic rating models] will not capture the intricacies of more complicated products.’

2.9 The claims handling process in the London insurance market

Claims handling is often considered as the litmus test or the ‘shop window’ (CII, 2013, p 10/2) for insurers as it transposes the promise made at the inception of the policy into something tangible. With a slight ironic undertone the CII (2013, p 10/2) continues on the link between the purchasing process and the claims process:

‘A purchaser of insurance will of course hopefully pay attention to their insurer at the time of purchase, and they might even read the policy wording and associated documents that are provided to them. It is at the time of loss [...] that the reaction and behaviour of the insurer’s claims team will leave a lasting impression of the insurer with the client.’

Furthermore, the CII (2013) argues that if claims are handled to the satisfaction of the policyholder then there is a good chance that the client will renew with the existing insurer.

In the London insurance market the broker is normally the first point of call and the broker’s first task, after being advised by the policyholder of a potential claim, is to review the policy document and to find out which insurers might be affected by the claim.

In section 2.7 the role of the lead underwriter as the main negotiator of the terms and conditions was mentioned. In the claims process the lead underwriter also plays a prominent role; however, the lead underwriter has not automatically the right to settle claims on behalf of the follow underwriters. The way claims are settled in the London insurance market will depend on the class of business and whether a Lloyd’s of London Syndicate or company market underwriter (or a combination of both) is involved. For example, for Lloyd’s of London there is a Lloyd’s claims scheme in place which specifies how claims are settled (Lloyd’s, 2010).

This claims scheme sets out, inter alia, that claims below £250,000 (standard claims) can be handled by the lead underwriter alone whereas claims between £250,000 and £500,000 need to be agreed by the first two syndicates on the MRC (Lloyd’s, 2010). The claims handling process can involve the use of experts, such as loss adjusters, and as highlighted in chapter 2.8 there are initiatives in place to improve and facilitate electronic trading (which includes electronic claims notification through ECF). The broker’s duty during the claims process is to

- Keep the policyholder updated on the claims handling process;
- Forward any new information (either from the policyholder or from loss adjusters);
- Negotiate with the insurer on behalf of the policyholder;
- Once the claim is settled forward monies received from the insurer to the policyholder. (CII, 2013)(See also 2.11 on the legal duties of the broker).

2.10 Issues arising from the insurance placing process in the London insurance market

A poll research report by Mactavish, a consultancy firm specialising in insurance governance, in cooperation with the consultancy firm, PwC, highlighted a number of issues associated with insurance buying by corporate clients. At the forefront is the realisation that corporate buyers are often not fully aware about the strict law governing insurance policies for corporate risks. The duty of disclosure by insurance buyers is absolute and the insurer needs to be informed about all fact material which might be relevant to a prudent underwriter in order to assess the risk.

The report also points out that a large number of insurance buyers do not review the material to be submitted by brokers to underwriters which forms the basis of the insurance policy. The study concludes that 'without detailed knowledge of what exactly is disclosed buyers are taking a blind leap of faith by assuming that important, low frequency high severity risks are adequately covered.' (Mactavish, 2011, p 14) In this context, Mactavish (2011) questions whether brokers are failing in their duty to advise clients appropriately about the legal disclosure requirement. The report defends brokers to some extent, by highlighting that it is impossible for them to be aware of all potential material facts a client may have to disclose given the workload of brokers, but also given the complexity of some of the risks being placed in the market.

The report also highlights that one of the concerns raised by brokers and insurance buyers is the increase in claims disputes. According to a survey conducted by the British Insurance Brokers' Association (BIBA), 64% of the brokers participating in the survey admit that they have to fight harder with insurers to get claims settled (BIBA, 2013). Mactavish (2011) do not see an outright refusal of claims as the main problem; rather it is delaying the final settlement by questioning, for example, the validity of lost profits figures for business interruptions claims. The report links this behaviour to the non-awareness of insurance buyers about their disclosure duties and the lack of scrutiny of the broker submission by clients which in turn enables insurers to dispute claims.

Mactavish (2011) criticises the way corporate insurance business is placed (mainly in the London market) and use the following diagram (Figure 14) to illustrate the issues at each stage of the insurance buying/underwriting process:

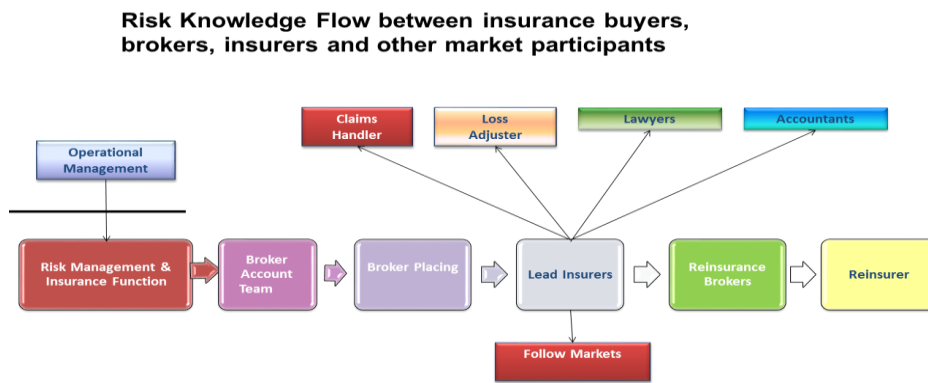


Figure 14 Risk Knowledge Flow (based on Mactavish, 2011)

For Mactavish (2011), the problem starts with the risk manager who is responsible for insurance buying in a large organisation. The increasing complexity of risks and the interconnectedness of supply chains would normally require a strong interaction between risk managers and day-to-day operational managers who have potentially a better knowledge about their risks. The next point which the report highlights is the strong reliance on undocumented information which can include verbal discussions between the risk manager and the broker, but also between the broker and the underwriter. In addition, Mactavish (2011) sees the relatively high staff turnover amongst underwriters, brokers and insurance buyers as a problem, as specific knowledge and expertise can easily disappear. All these factors can contribute to a higher number of claims disputes.

As regards the placement process, the report points out that insurance buyers see this process as a ‘black box’ (Mactavish, 2011, p 21). This is mainly due to limited direct contact of insurance buyers with underwriters as risks are mainly placed through brokers. The report argues that this makes it difficult for insurance buyers to understand what a *prudent underwriter* needs to know or what he cares about. Another point the Mactavish (2011) study makes which resonates with a survey sponsored by the Financial Services Authority (FSA, 2005) that it is difficult for insurance buyers to fully understand insurance coverage because of the opaque wording. In the FSA (2005) survey, private consumers reported a similar concern about the ‘small print’ of terms and conditions. The Mactavish report (2011, p 22) report quotes an audit manager in manufacturing to illustrate this point:

‘I don’t know what we’re covered for. You simply cannot tell and I’ve never had any clarification from the broker. As a layman, when you look at the insurance policy and ask “are we covered?” the answer is often “I’m buggered if I know”.’

Another issue Mactavish (2011) highlighted is the potential disconnect between the broker team responsible for client contact (account team) and the placement broker. The last point the Mactavish report makes is the potential information asymmetry between the insurance buyers and follower markets as well as reinsurers. Mactavish (2011) argues that these parties may have a strong influence when it comes to claims disputes. In addition, the extensive placement chain makes it difficult to have full transparency of the placement system for insurance buyers.

2.11 Utmost good faith and the implications for corporate insurance buyers

A contract of insurance is a one of the few contracts where the principle of *uberrimae fidei* or utmost good faith applies, the others being for example, family arrangements (Birds, 2013). This principle requires the potential parties to an insurance contract (i.e. the insurer and the future policyholder) to furnish each other with the necessary information which enables both parties to decide whether to conclude an insurance contract. The consequences of not meeting the requirement of utmost good faith are harsher for the policyholder as the insurer is entitled to avoid the contract *ab initio* if there is a failure to disclose, however innocent (Birds, 2013). The rationale for this stringent requirement was laid down in the leading case *Carter v Boehm* [1766] 3 Burr. 1905 and Lord Mansfield highlighted:

“Insurance is a contract upon speculation. The special facts, upon which the contingent chance is to be computed, lie most commonly in the knowledge of the insured only: the under-writer trusts to his representation, and proceeds upon the confidence that he does not keep back any circumstance in his knowledge, to mislead the under-writer into a belief that the circumstance does not exist and to induce him to estimate the *risqué* as if it did not exist.”

As the Law Commission points out the duty of disclosure is very onerous upon the policyholder putting him at a disadvantage over the insurer (Law Commission 2012). However, Bird (1996) believes that the way how subsequent courts - in a doctrine like fashion - have interpreted Lord Mansfield’s rule may not reflect his intention, although this is merely an academic question nowadays. However, Bird (2013) clearly saw a case for reforming these strict rules which clearly resonates with the Law Commission report. Park (1996) sees these strict rules as particular feature of insurance contract as in all other commercial contracts the principle of good faith applies which is less onerous than utmost good faith. This may have to do with the nature of

insurance contracts which require 'mutual trust and confidence between the insurer and the insured.' (Park, 1996, p 1)

Park (1996) sees as one of the reasons for establishing the utmost good faith principle in English law, the original process of marine insurance underwriting. At that time, it was difficult for the insurer to inspect the ship which it was being asked to underwrite, so had to rely solely on what the insured described before making a decision. Hence, there may have been a need for a stricter disclosure requirement.

The harsh treatment of policyholders who fail to disclose and in particular the all or nothing principle of contract avoidance has also been criticised by Donald Nicholls V.C. in *Pan Atlantic Insurance Co. Ltd v. Pine Top Insurance Co. Ltd* [1994] 3 All E.R. 581 :

"Justice and fairness would suggest that when the inadvertent non-disclosure came to light what was required was an adjustment in the premium or, perhaps, in the amount of cover. Those are not options available under English law. The remedy is all or nothing. The contract of insurance is avoided altogether, or it stands in its entirety. This is not the only field in which the English law still seems to adopt an all-or-nothing approach, when what is needed is a more sophisticated remedy more appropriate, and in that sense more proportionate to the wrong suffered."

The broker's role and duty relating to the insured

Henley (2004, p 3) sees the following features of an insurance broker: 'He is effectively a negotiator who attempts to obtain the best possible terms for a contract which is speculative in that the anticipated loss may not occur and is outside the control of the parties. In fact his primary obligation is to introduce the party for whom he acts, the principal who will become the insured, to another party who is able to provide the right type of insurance for the right price, period and terms.' Cummins and Doherty (2006, p 360) describes the role of an intermediary in the commercial non-life market as 'market maker' by supporting insurance buyers in identifying insurance needs and finding the appropriate insurer. Cummins and Doherty (2006) acknowledge that this process can be cumbersome as the broker has to scan the market, try to find an underwriter with necessary underwriting skills, capacity, financial strength and the willingness to underwrite the presented risks. In addition, the broker needs to help the insurance buyers to choose between competing offers. The relationship between an insurance broker and a policyholder is thus that between an agent and a principal through a contractual agreement.

Thoyts (2010) considers the following main tasks of an insurance broker:

- Preparation of proposals/risk details
- Placement of cover
- Payment of premiums
- Submission of claims
- Payment of claims

The broker would typically approach an underwriter or a number of underwriters in the London market to receive a quotation for a risk he/she wishes to place with insurers. As mentioned above the duty of disclosure is very strict requiring the proposer to disclose all material facts which the underwriter ought to know in order to evaluate the risk. As the broker acts as an agent of the proposer, the broker will have to ascertain all material facts, on one hand; on the other hand, the proposer/corporate client will have to rely on the broker to ensure he asks the right questions and relays all the information to the insurer. Regardless of who fails to disclose all material facts, the insurer will always be entitled to repudiate the contract, although the insured may be able to claim damages from the broker if he fails in his duties. Thoyts (2010) points out that whilst insureds have a duty of utmost good faith, intermediaries or brokers only have a duty of good faith which places a lesser burden on him/her. There are a number of court rulings dealing with individual cases and Henley (2004) concludes that the duty of good faith requires the broker to exercise his agency duty with reasonable care and there 'must be a limit to the exercise that the brokers have to perform, and the imposition of liability by the court will depend on the circumstances in each.' (Henley, 2010, p 401)

In *Darville v E.A. Notcutt & Company Limited* the court commented –inter alia - on some of the broker's duties:

- a) "Whilst it is the broker's job, as an agent for his client, to help him ascertain the material facts, the broker does not have to reach the standard of a "detective or enquiry agent";
- b) [...] "he must ensure that his client understands that he must disclose all material facts... to pass it on to underwriter."
- c) [...]
- d) [...]
- e) In response to evidence from the plaintiff's broking expert that the broker should "hold the hand" of the client, the Court held that the broker should "help him, yes, guide him

certainly, advise him, of course, but not hold his hand or ferret for information”.’(cited in Henley, 2004, p 400)

When it comes to the payment of premiums, the broker is normally responsible for the collection of premiums; however, the agent/principal relationship changes so that the broker becomes an agent of the insurer because the firm will normally authorise the broker to accept payment on the insurer’s behalf (Thoyts 2010). This means that if the insured has paid premiums to the broker, but the broker fails to pass on the payment to the insurer, the policy cannot be repudiated for non-payment.

The Marine Insurance Act (1906) stipulates that the broker is responsible to the insurer/underwriter for the premium and the underwriter can request the premium from the broker even he/she has not received it from the insured. This also means that the insurer has only a right to sue the broker if premiums have not been received and not the insured. However, even if the broker has not paid the premium to the underwriter, the underwriter is still liable to pay for losses under the insurance policy to the insured. (Law Commission, 2010)

In respect of claims submission and claims payments the broker acts again as agent of the insured. This means that broker will negotiate with the insurer on the insured’s behalf and settle the claim with the insurer. In the London market it is also common practice that the broker receives the claims payment which the broker is expected to pass on to the policyholder. However, here the broker reverts back to being an agent of the insurer which means that only once the claims payment reaches the policyholder the claim is deemed to be settled (Thoyts 2010).

Because of the significant premium money flow between the insured and the broker which will not necessarily be immediately transferred to insurers, there are regulations in the European Union in place to protect clients’ money from the inability of an insurance intermediary to transfer premiums to the insurer or to transfer the proceed of a claim or premium refund to the insured. The Insurance Mediation Directive (IMD, 2002) sets out the rules for client money protection handled through insurance intermediaries. In the United Kingdom the Directive was transposed into national law through the Client Assets (CASS, 2013) regulation (previously by the FSA now FCA) Financial Conduct Authority Client Assets Rules 2013 which also cover other aspects of client money, such as asset management activities. Failure to comply with client money rules by brokers can incur significant fines. For example, a Stephen Goodwin was forced

to pay a penalty of £471,846 by the FSA in July 2012 because he did not pay premiums received from the insured to the relevant insurers (FSA Final Notice, 2012).

2.12 The Law Commission's Consultation paper on Insurance Contract Law

The principle of utmost good faith for insurance contract has found widespread criticism for decades (Park 1996) and the question whether this can lead to abuse was considered by the Law Commission as early as 1957 (cited in Park, 1996). Park (1996 p xi) argues that 'the issue of non-disclosure is widely used as a technical defence against claims by the insurance industry'.

Tarr (2002) points out that actuarial and technical methods to assess risks by insurers have significantly advanced and these would be unrecognisable to underwriters in the 18th century, when utmost good faith was first established. There is a difference between underwriters at that time having to rely on 'the word of the shipowners and the captains as to what risks lay in the remote ports to which their vessels would sail.' (Tarr, 2002, p 2). The fact that despite the development in insurance underwriting, risk assessment and pricing the principle of utmost good faith is still in place puts an unfair burden on insureds.

Following from previous consultations on Insurance Contract Law which resulted in a change of legislation in consumer insurance law, the Law Commission published a consultation paper titled 'Insurance Contract Law: The Business Insured's Duty of Disclosure and the Law of Warranties' (Law Commission, 2012). The consultation paper highlights the potential undue burden on the policyholder for commercial insurance. Under the Marine Insurance Act 1906 a policyholder must disclose 'every material circumstance' which he knows or ought to know 'in the ordinary course of business'.

The Act defines a material circumstance as 'every circumstance which would influence the judgement of a prudent insurer in fixing the premium, or determining whether he will take the risk.' The paper argues that this duty is very stringent and requires the policyholder 'to look into the mind of a hypothetical prudent insurer and work out what would influence it.' (Law Commission, 2012, p 7). This second guessing, what an insurer might need to know, can become very difficult or nearly impossible if the business to be insured is very complex, for example for a business which is looking for insurance cover for its global network.

The consultation paper points out that Marine Act might encourage a passive role of the underwriter by relying solely on what the policyholder discloses rather than asking what he needs to know to evaluate the risk. Underwriters are thus enticed to write a risk –regardless of how well it was presented – and only ask specific questions when a claim arises. The Law Commission describes this behaviour as ‘underwriting at claims stage’ (Law Commission 2012, p 7).

The problem is that if the underwriter detects a material non-disclosure the only remedy is the avoidance of the insurance contract. This leaves the underwriter in a powerful position as a policyholder could lose the entire insurance cover if he/she fails to disclose a relatively small issue for which the underwriter would only charge a small additional premium.

The report acknowledges that not all problems are caused by the law. However, the Law Commission argues that the non-disclosure law has exacerbated some of the issues. In particular the Law Commission points out (Law Commission 2012, p 45):

- (1) ‘Policyholders fail to understand it [the law] – not because the words are complex, but because the concept is counter-intuitive. Despite continual warnings, few policyholders believe that the law really expects them to second-guess what the insurer wants to know. Even if they do believe it,
- (2) They have little idea of how to set about the task.
- (3) Section 18 of the 1906 Act fails to clarify whose knowledge within a company is relevant, and what those who place insurance must do to gather information in order to make proper disclosure.
- (4) Insurers have insufficient incentive to ask questions before underwriting a risk. The law gives the impression that insurers are entitled to write any risk, however inadequately presented, and asks questions only once a claim arises.
- (5) The remedy for non-disclosure is unduly harsh. A policyholder who fails to mention a minor issue loses all the benefit from the policy, even if the insurer would only have added a small amount to the premium had it known the true facts.’

The Commission points out that litigation in the area of the duty of disclosure is significant. Based on their own research, the Commission estimates total litigation costs in England and Wales over the last ten years as shown in Table 6:

Table 6 Estimated costs of non-disclosure disputes (based on Law Commission, 2012)

Number of disputes	Average cost per case	Total costs in category (£million)
12 appeals	Additional £35,000	0.4
26 High Court judgements	£400,000	10.4
624 cases where proceedings were issued (but which did not proceed to trial)	£100,000	62.4
6,350 disputes where not proceedings were issued	£25,000	158.8
Total costs for policyholders		232.0
Total costs for insurers (assuming similar levels)		232.0
Overall total for both parties over 10 years		464.0
Costs per year		46.4
Estimated legal fees per annum		50.0

The consultation acknowledges that currently outright rejections of claims are relatively rare and many claims are settled with an ex-gratia payment. However, there is a concern that when there is a hard market insurers could be more inclined to exercise their legal rights (i.e. avoiding the contract) thus leaving the policyholder stranded (Law Commission 2012). The consultation emphasises the serious consequences this may have (Law Commission 2012 p 204): 'Without the expected claims payment, the firm may not be able to resume trading, leading to insolvency. This would have potentially serious consequences, not just for shareholders but also for employees, creditors and the economy as a whole.'

A recent survey amongst AIRMIC members (AIRMIC, 2012) showed that 10.8% of respondents had a claim challenged by an insurer on grounds of non-disclosure between 2010 and 2011. In terms of the size of the claim there appears to be a tendency by insurers to either dispute smaller claims or dispute very large claims.

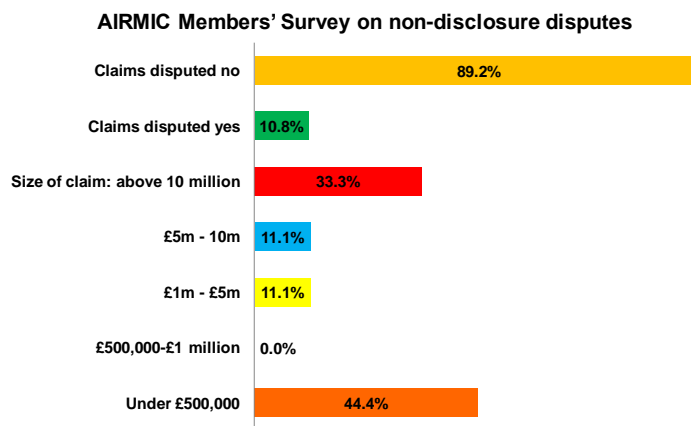


Figure 15 AIRMIC non-disclosure survey (Source: AIRMIC 2012)

Hertzell and Burgoyne (2013) summarised the responses to the Law Commission's consultation paper. The majority of consultees favoured the proposal to abolish the rule that a policy would be void *ab initio* if there is a breach of duty of disclosure. For example, respondents considered this rule as either "an unfair bludgeon", "draconian" or an "all or nothing approach" (p 111). Hertzell and Burgoyne (2013, p 111) also quoted Royal & Sun Alliance, one of the largest commercial insurers in the UK, which emphasised that avoidance "does not reflect what RSA considers to be reasonable business practice in the modern age."

The Law Commission published a final report in July 2014 incorporating the consultation responses and a draft Bill (The Law Commission, 2014). Commenting on the Law Commission's consultation paper, Birds (2013) believes that the duty of disclosure is likely to be retained for commercial insurance. However, the provision of the Marine Insurance Act regarding this issue is to be replaced with 'a more modern formulation, putting the emphasis on the duty of a proposer to make a fair presentation of the risk. Most importantly, they [The Law Commission] seem likely to recommend that a contract should remain voidable only for a fraudulent non-disclosure or misrepresentation.' (Birds, 2013, p 154)

2.13 Contract Certainty

Historically, insurance policies and the detailed terms and conditions, especially for larger complex risks, were not always supplied to the policyholder prior or at the time of the transaction. This has led to a significant contract uncertainty and also to asymmetrical

information. This issue became a major problem following the World Trade Centre (9/11) attacks where the basis of the contract and the policy wording was not clear. As a result, the claimant, the owner of the property, sued insurance companies who provided insurance cover for this building to pay out a significantly higher sum than they were offering.⁵

This issue was highlighted by former CEO of the FSA, John Tiner, during a speech in New York in 2004 (Tiner, 2004). Using the Silverstein case as an example Tiner (2004) argued that ‘the industry has underinvested in technology and in process improvement and it has become a field day for lawyers who pick up the pieces when an insured makes a claim on cover which they believe has been underwritten, but for which policy wording has not been agreed.’

As a consequence of the wording uncertainty which arose out of the Silverstein claim, Tiner (2004) promoted the introduction of contract certainty which means that there should be greater certainty about the insurance cover at the inception of the policy and a full policy wording available shortly thereafter: ‘We want to see the end of a practice which is “deal now, detail later”. The lack of contract certainty creates risk for the policyholder as well as the insurer and the brokers. For underwriters there is substantial operational risk related to pricing and documentation errors and delays which create uncertainty.’

Following from this speech, the FSA and the insurance industry agreed to find a ‘market-driven solution to the issue of contract certainty within two years’ (FSA, 2004). Addleshaw Goddard (2005), a law firm, points out that contract uncertainty, especially when simply stating “wording to be agreed” or “wording: as original” has led to a barrage of litigation thus incurring huge legal costs. Referring to the former Chief Executive of Lloyd’s of London, Nick Prettejohn, Addleshaw Goddard (2005) points to approximately £500 - £600 million in legal fees spent by Lloyd’s of London every year mainly because of contract uncertainty.

The “deal now, detail later” can be traced back to a time when business was based on personal relationships, rather than professional relationships (Murray, 2011). The majority of insurance policies now meet contract certainty standards (LMG, 2014). However, there is a concern that by focusing too much on compliance the culture of “deal now, detail later” might be replaced with “detail now, dispute later”. (Addleshaw Goddard (2005, p 3).

⁵ For further details of this issue see various press releases from insurers involved, such as Allianz and Swiss Re regarding the Silverstein claim.

2.14 Conclusions

This chapter has discussed the main features of the London Insurance Market and how business is placed in this market which is summarised in Figure 16:

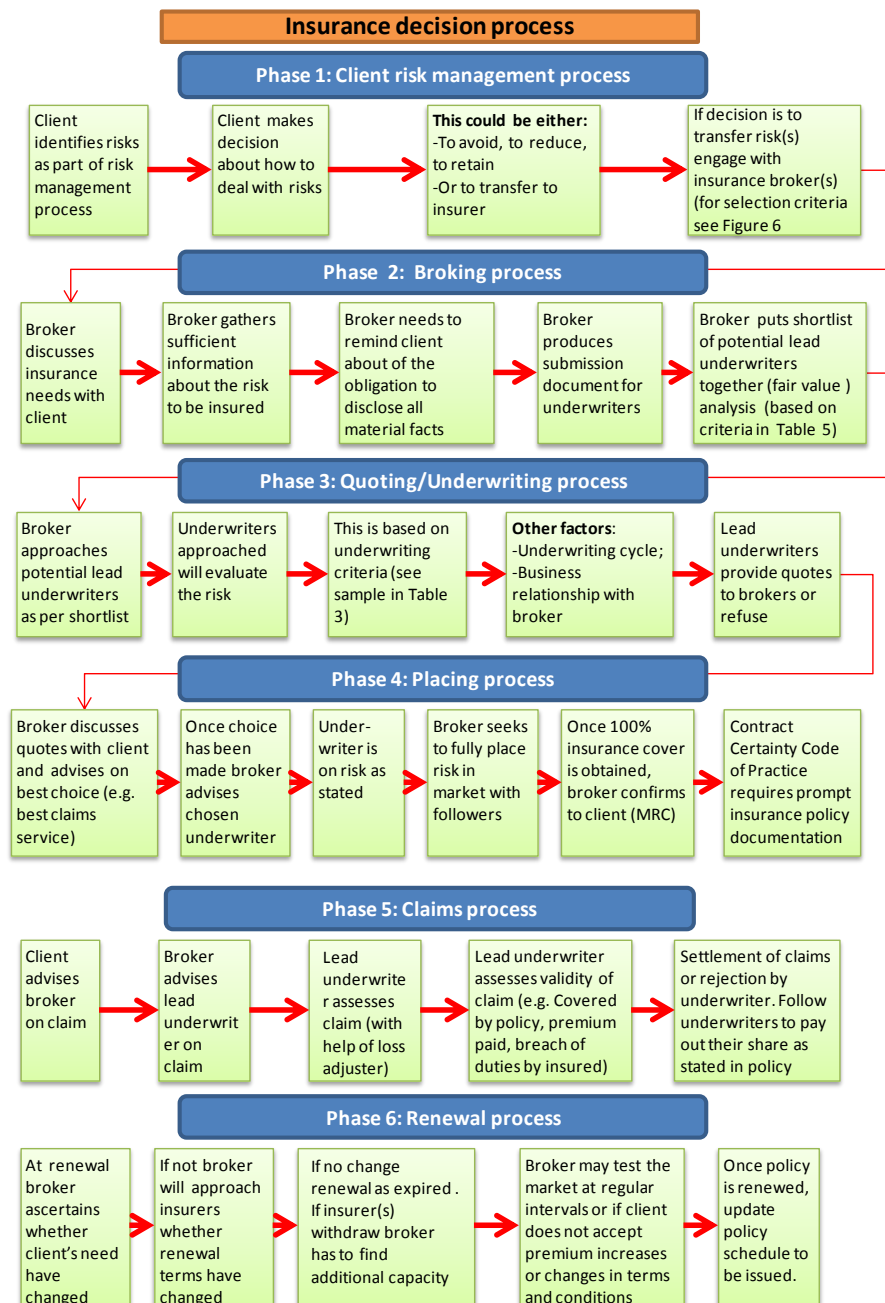


Figure 16 Insurance decision process (own diagram)

In addition, problems arising out of this process have been highlighted. In particular, the principle of utmost good faith puts a high burden on policyholders to disclose all material facts to the insurer which in turn provides the underwriter with a powerful instrument to avoid claims.

Despite the increasing focus on electronic trading, the London Market is still considered as a place where face-to-face negotiations between underwriters and brokers are vital for the functioning of the market. This proximity of underwriters and brokers in the City of London enable close business relationships, but also personal relationships between market participants and create different human dynamics than, for example in the retail insurance sector (IBM, 2008)

These face-to-face negotiations and close business or even personal relationships create unique dynamics in the London market which in turn might call for a bigger role of reputation and trust compared to other market places. In addition, the nature of insurance which promises to pay claims in the future gives rise to a more prominent role of reputation and trust. Following from the discussions in this chapter about the concept of insurance, the main features and the placing process in the London insurance market, below is a summary of the key issues which emerged, including the potential role of reputation and trust:

- **Face-to face relationships:** The London insurance market is a unique market place due to close proximity of the market participants in the City of London (TheCityUK, 2011). Personal relationships and trust play an important role in this close-knit market community (Jarzabowski et al, 2010). The London insurance market is also a subscription market where terms and conditions are negotiated between the broker and a lead underwriter who is offered the business because of he/she is seen as an expert in a class of insurance business and has a reputation for being able to underwrite the risks being offered by the broker. Choosing a lead underwriter whose judgement is trusted will make it easier for the broker to place business with followers in the market (Thoyts, 2010).
- **Underwriting cycles:** Underwriting cycles are an important feature of the London market. However, the specialist nature of the London market may to some extent dampen the volatility of premium rates. Indeed, AON (2013, p 15) highlight in respect of international liability (casualty) business: ‘The quality of the underwriter and client relationship is important in casualty business and consequently most buyers do not move lead markets frequently.’ This means that insurance buyers do not very often

switch the lead underwriter because price is less important than in other classes of business.

- **Broker dominated market:** The majority of business in the London market is normally negotiated via brokers. The role of the brokers is to be a 'market maker' (Cummins and Doherty, 2006, p 360) who supports the insurance buyer by identifying insurance needs and finding the appropriate insurer. The Standard & Poor's survey on factors influencing broker selection amongst European insurance buyers (S&P, 2011) highlight the importance of relationships and trust: 'a breakdown of trust, perceived disloyalty of the broker and concerns about transparency' (S&P, 2011, p 17) can cause a client to change the broker.

Summary

Based on discussion about the role of the broker in the intermediation process, there might be a number of areas where reputation and trust play an important role:

- *Placing of business and duty of disclosure:*
 - The corporate client expects a broker to understand his/her business, so that the broker is able to select the appropriate underwriter(s) who are able to price the risk and provide adequate insurance cover. Cummins and Doherty (2006, p 362) believe that this requires a 'significant degree of mutual trust' as the insurance buyer 'relies on the relationship between the intermediary and insurer when placing risks. An intermediary needs strong relationships with insurers to place business on advantageous terms'.
 - The client will also seek guidance on what information is required by the underwriter. As mentioned above the duty of disclosure is extremely strict under English Law whereas the duty of the broker to act as an agent of the client is less strict (duty of good faith or reasonable care). The corporate client/insured will have to trust that the broker has the necessary expertise and experience not only in placing the, but also in ensuring that the insured discloses all the necessary information to the underwriter
 - *Payment of premiums and payment of claims:*
 - Here the principal/agent relationship reverts from the broker to the insurer, especially in the London market. In both cases it is the insurer who has to rely on the broker that he acts in good faith. Whilst there are regulations in place, insurer can never be totally sure that brokers

will have separated client money and placed in trust accounts. As such, the reputation of broker in dealing with his fiduciary duty will play a role for insurers when dealing with brokers.

Maas (2010) highlights that the ability to build relationships and trustworthiness with clients is a crucial success factor. Especially, larger corporate clients who have to deal with large complex risks and who are also increasingly interested in using brokers' consultancy service (such as risk management consultancy) want to deal with experts they know and can trust.

- **Utmost good faith:** The Law Commission's report on the duty of disclosure clearly highlights the conundrum policyholders are facing. They are not fully aware of what the law requires them to do in terms of disclosing all material facts which in turns leaves uncertainty whether they have fulfilled their duty, so that the contract is not void. So policyholders have to trust the insurer that they will ask for all the relevant information which enables the underwriter to assess and price the risk. In addition, policyholders could face a long period of uncertainty between the issuance of the contract and the occurrence of a claim where only then they might find out that the insurer did not bother to ask the relevant questions and instead is disputing the claim. As pointed above, this can have disastrous consequences, not only for the policyholder, but also for the wider economy. Therefore reputation can play a twofold role:
 - Policyholders and brokers will evaluate whether the insurer has a reputation for disputing or even trying to avoid claims wherever possible
 - Reputation can work as sanction mechanism. If the insurer knows that his ability to generate or retain business is affected by his behaviour (i.e. disputing or trying to avoid claims on grounds of non-disclosure) then the underwriter might reconsider his/her decision.
- **Claims settlement:** The willingness to pay claims and the way how insurers deal with claims is a major concern for clients and thus a main criterion for selecting insurers. Because of the time lag between the inception of the insurance policy and the emergence of claims there is uncertainty for policyholders and brokers about the future behaviour of insurers. Even if an insurer does not try to use the breach of duty of disclosure to void an insurance policy, the insurer can still try to avoid paying a claim by arguing that a specific claim is not covered by the policy or the insurer can delay claims payments to detriment of the policyholder. Both brokers and policyholders will judge whether they can trust an

insurer that the insurers is either willing or able to pay claims after the inception of an insurance policy.

- **Underwriting is judgement under uncertainty:** Underwriters are making decisions under uncertainty (Kunreuther, 1995) as there is uncertainty about the number of claims and the amount of claims payments (Rejda, 2008). Hence, underwriting is a complex process which requires a significant amount of judgement (CII, 2010)

As highlighted above, there are already a number of areas where reputation and/or trust might play a role in decision making. Underwriters in the London market make judgement-based decision under uncertainty. Insofar, the concepts of behavioural decision theories are relevant for the understanding of the decision processes in the London market. The generic role of reputation and trust and the more specific role for the insurance will be discussed in the next chapter. This will be followed by a discussion of relevant concepts of behavioural decision theories.

3 Reputation and Corporate Reputation

3.1 Introduction

In the previous chapter, a general overview of the concept of insurance together with an overview of market participants in the UK insurance market was provided. Furthermore, the previous chapter discussed the functioning of the London insurance market which included underwriting in a subscription market, the placing process and the claims handling process. The chapter also highlighted issues arising from the placing process. In particular, it was stressed that the principle of utmost good faith, which requires policyholder to disclose all material facts to the insurer, puts an undue burden on the policyholder and potentially gives insurers an easy way out if they see to avoid claims.

Following from the discussions in Chapter 2, a number of areas where reputation and trust might play a role have emerged (see Section 2.14) and these areas will be further explored in this thesis. The objective of this chapter is to provide a better understanding of the concepts of reputation and trust by critically reviewing the literature in this field. This also covers how reputation and trust interrelate with each other in the decision making process. A particular focus will be on reviewing the existing literature on the notion of reducing the complexity of decisions through reputation and trust. (A discussion on decision making theories is provided later in chapter 4). In addition to exploring reputation, the similar concepts of corporate identity and corporate image will be discussed and how they differ from reputation. Finally, this chapter examines whether there is a specific role for reputation and trust in the insurance sector given the intangibility of the insurance product.

Before discussing the concept of corporate reputation, it is important to understand the more general definition of reputation. Etymologically reputation stems from the Latin word 'reputatio' and a generic definition is provided by Merriam-Webster as the 'overall quality or character as seen or judged by people in general' Merriam-Webster (2009). This more general definition already highlights some potential aspects of corporate reputation namely that there is an evaluate process before forming an opinion about the quality (of a product) or the character (of an individual). The mechanism of reputation will be discussed in the next sections.

3.2 Corporate reputation and other related concepts

3.2.1 Divergent views of corporate reputation

As the general definition highlights, reputation is a well-established concept and is part of daily life. However, academic research relating to the concept of reputation pertaining to firms (i.e. corporate reputation) only intensified in the early 1990s. Although progress has been made, researchers are still attempting to come up with a generally accepted definition. Even to date, there still exist a wide ranging view about the definitions, functions and benefits of corporate reputation. Formbrun (1996) explains this by the fact that reputation rarely gets noticed unless it gets damaged. Formbrun and van Riel (1997) point out that differing academic schools of thought are also a contributing factor. The authors identified six distinctive views on reputation, namely an economic, a strategic, a marketing, an organisational and an accounting approach which makes it difficult to integrate them into one single denominator. Chun (2005, p 91) sees corporate reputation as a relatively new academic subject, but one which is 'still dogged by its origins in a number of separate disciplines.'

Gotsi and Wilson (2001, p 24) concur with this observation, but add that even 'within the marketing discipline there is no consistency in defining the concept of corporate reputation'. They also conclude that this is due to divergent academic strands within marketing which define corporate reputation and the similar concept corporate image (see Section 3.2.3) either as synonymous or different concepts. Mahon (2002) points out that very often parallel research in the various disciplines is ignored which in turn contributes to the slow progress being made in developing a common understanding across all academic disciplines.

Barnett et al (2006, p 26) also come to the conclusion that 'while the interest in the concept of corporate reputation has gained momentum in the last few years, a precise and commonly agreed upon definition is still lacking'. They agree with Gotsi and Wilson (2001) that there is still confusion about the associated constructs of *identity*, *image* and *reputation*. Wartick (2002) adds that research in respect of corporate reputation has not yet provided an answer as to the appropriate measurement of this construct.

Before discussing the different approaches to corporate reputation, the similar concepts identity and image shall be considered. This is important in order to get a clearer understanding of what corporate reputation means as these three constructs are often closely linked together.

3.2.2 Differentiating corporate identity

Similar to corporate reputation, there have been attempts to develop a generally acknowledged definition of corporate identity. Melawar and Jenkins (2002, p 76) argue that despite 'significant contributions [...], a definite construct of corporate identity and its measurement does not yet exist'. Westcott Alessandri (2001) points out that due to the immaturity of this academic field, corporate identity is rarely defined in a definite way. This has partially to do with the fact that this subject has attracted more attention from practioners rather than academics.

Starting with Merriam-Webster, identity is, inter alia, defined as 'the distinguishing character or personality of an individual' (Merriam-Webster, 2009). For individuals, Luhmann (2000) sees identity as a portrayal of oneself. From the perspective of an organisation or corporation the aforementioned definition can be extended to mean the self-description of an organisation. It can be a written statement or another medium by which a corporation identifies itself (Luhmann, 2000).

Westcott Alessandri (2001, p 177) offers two further definitions, a conceptual and an operational one: The former is 'a firm's strategically planned and purposeful presentation of itself in order to gain a positive corporate image in the minds of the public. A corporate identity is established in order to gain favourable corporate reputation over time'. The latter is 'all the observable and measurable elements of a firm's identity manifest in its comprehensive visual presentation it itself' (Westcott Alessandri, 2001, p 177). Van Riel (1997, p 290) sees in line with Luhmann (2000) and Westcott Alessandri (2001), corporate identity as 'the self presentations of an organisation, rooted in the behaviour of individual organisation members, expressing the organisation's "sameness over time" or continuity, "distinctiveness" and "centrality"'.

Melawar and Jenkins (2002) argue that corporate identity is 'central to the existence of the organisation.' For Bromley (2000) this means that corporate identity distinguishes one company from another. The identification of an organisation with itself is critical, as it enables to build up expectations for its stakeholders. Organisations who aim to portray themselves should ensure that the identity they present to stakeholders is what they actually are as this is essential to create trust. Therefore corporate identity is not just about self portrayal, but also about synchronising self presentation and behaviour (Luhmann, 2000).

3.2.3 Understanding Corporate Image

The confusion about what corporate image constitutes is even greater than that about corporate identity. Very often corporate image and corporate reputation are seen as interchangeable or are mixed up (Herger, 2006). Gotsi and Wilson (2001) explain this by the different schools of thought. They observed that especially in early research there was a focus on corporate image which might explain why corporate reputation is seen as synonymous with corporate image. Rindova (1997) argues that a public relations background may also be a reason for this view. Chun (2005) points out that the definition of reputation by individual researchers depends on how they consider identity and image in the context of reputation. Similar to Herger (2006), Chun (2005, p 95) highlights that 'reputation is often used synonymously with image, and this can lead to confusion.'

However, the majority of literature on this subject tends to regard corporate image as different from corporate reputation, albeit closely related (Eberl, 2006). Gray and Balmer (1998, p 696), who are supporting the differentiation school, see corporate image as 'the mental picture of the company held by its audiences - what comes to mind when one sees or hears the corporate name or its logo'. Barnett et al (2006, p 34) confer with this, but extend it so that corporate image becomes 'an observer's general impression of a corporation's distinct collections of symbols, whether that observer is internal or external to the firm'. Helm (2007) points out that corporate image is mainly a result of communication measures and as such does not necessarily require trust and does not involve evaluation (which distinguishes it from reputation and which is discussed below). It only provides a subjective and individual picture of a corporation. Both definitions of Gray and Balmer (2008) and Helm (2007) provide a clear distinction between corporate image and corporate reputation.

3.2.4 Developing a definition of corporate reputation

Earlier, it was highlighted that a generally acknowledged definition has not yet been found. In this Section a selection of definitions shall be introduced and a working definition for the purpose of this thesis will be offered.

Reputation is seen as a dazzling, trendy concept (Herger 2006), but Formbrun and van Riel (1997) point out that 'although corporate reputations are ubiquitous, they remain relatively

understudied.’ However, what most authors can agree on is that reputation matters as, for example, it can create competitive advantage (Mahon, 2002). Rayner (2003, p 3) argues that ‘it is increasingly recognised that a good corporate reputation is a highly prized intangible asset – one which, if nurtured and protected, can continue to grow in value over time.’

As mentioned, there is a plethora of opinions about what corporate reputation is and a sample of different definitions of corporate reputation illustrates the diverging perspectives of this concept (Table 7):

Table 7 Overview of corporate reputation definitions

Authors	Definition
Baden-Fuller et al, 2000	‘An evaluation of an organisation’s resources and capabilities by a clearly defined audience. This definition incorporates the economists’ view that reputation is a predictor of behaviour.’
Barnett et al, 2006	‘Observers’ collective judgements of a corporation based on assessments of the financial, social and environmental impacts attributed to the corporation over time.’
Bromley, 20002	‘Reflects a firm’s relative standing, internally with employees and externally with other stakeholders, in its competitive and institutional environment.’
Formbrun, 1996	‘The overall estimation in which a company is held by its constituents’. and ‘A perceptual representation of a company’s past actions and future prospects that describes the firm’s overall appeal to all of its key constituents when compared with other leading rivals.’
Gotsi and Wilson, 2001	‘A stakeholder’s overall evaluation of a company over time. This evaluation is based on the stakeholder’s direct experiences with the company, any other form of communication and symbolism that provides information about the firm’s actions and/or a comparison with the actions of other leading rivals.’
Helm, 2007	The ability and willingness to deliver goods or services appreciated by the corporation’s stakeholders. (translated from German)
Mahon, 2002	‘Expectations of organizational behaviour based on past actions and situations.’
Rayner, 2003	‘A collection of perceptions and beliefs, both past and present, which reside in the consciousness of an organisation’s stakeholders – its customers, suppliers, business partners, employees [...] and the public at large.’
Wartick, 1992	‘The aggregation of a single stakeholder’s perceptions of how well organizational responses are meeting the demands and expectations of many organizational stakeholders.’

The above definitions highlight the complexity of this construct. Whilst a number of authors emphasise the perceptive element of corporate reputation (Formbrun, 1996, Wartick, 2002, Rayner, 2003) others stress the judgemental or evaluative nature of reputation (Baden-Fuller, 2000, Barnett et al, 2006, Gotsi and Wilson, 2001). From the onset it appears that perception and judgement are two different concepts and indeed Merriam-Webster (2014) offers in respect

of judgement the following definition: 'the act or process of forming an opinion or making a decision after careful thought: the act of judging something or someone.' Perception, on the other hand is defined as 'the way that you notice or understand something using one of your senses' (Merriam-Webster, 2014). In the context of risk perception, Renn (2004) points out that in cognitive psychology the term perception is seen as a mental process which handles information through the senses, and which appears to be similar to the definition offered by Merriam-Webster (2014). Concerning judgement, Kant sees judgment as 'complex conscious cognitions' (cited in Hanna, 2014). Concluding from this, perception and judgement could be regarded as different concepts with perception focusing on the senses whereas judgement focuses on forming an opinion in order to make a decision.

Yoon (2003), see reputation as a quality assessment rather than overall evaluation of a firm whereas Bromley (2002) see reputation more as a comparative measure. Atkins et al (2006, p 23) approach reputation through the definition of reputational risk, which they see as a 'failure to meet stakeholders' reasonable expectations of an organisation's performance and behaviour.' Whilst a discussion of reasonable expectation would go beyond the remit of this thesis, the definition of reputational risk by Atkins et al (2006) highlights that organisations would have to do something which stakeholders can evaluate (through their reasonable expectations). Consequently, reputation is built through the evaluation of past actions or behaviours of organisation which also means that it not sufficient just to perceive something. Emler (1990, p 178) points to the judgemental feature of reputation by highlighting that 'reputations are also judgements, about vices and virtues, strengths and weaknesses, based on accumulating patterns of evidence which societies constantly process and reprocess.' The author also emphasises that most organisations have informal systems in place via which decisions are being made. Individuals who operate in such systems can be more effective if they know about the other individuals they are dealing with and reputation can provide this information.

Notwithstanding the variety of definitions, there appear to be a number of common elements evolving:

- Corporate reputation involves an element of evaluation or judgement on the part of particular stakeholders (see Gotsi and Wilson, 2001, Barnett et al, 2006, Baden-Fuller et al, 2000)

- The judgement is based on actions or behaviours, be it financial, social or environmental, of an organisation (see Barnett et al, 2006, Formbrun, 1996, Mahon 2002)
- These actions which are evaluated create expectations for the future (see Mahon, 2002, Formbrun, 1996, also Yoon, 1993 in respect of product quality)

Based on the above, the following definition for corporation reputation will be used:

Corporate reputation can be regarded as a judgement of various aspects of an organisation's (which includes individual members of an organisation) past actions by its various stakeholders, which will cause these stakeholders to evaluate their (different) expectations about the prospective behaviours of the organisation.

Note that this definition need not apply only to stakeholders who have previous direct experience of an organisation (and its members), but could include new clients or new stakeholders without previous hands-on experience with an organisation. Such new clients or new stakeholders will form a judgement through media or other channels, such as intermediaries, to evaluate their (different) expectations about the prospective behaviours of an organisation or individuals. (Gotsi and Wilson, 2001)

3.3 The Interaction between Corporate Identity, Image and Reputation

Based on Luhman (2000) corporate identity can be seen as the self-presentation of an organisation or how it wants to be seen. Corporate image is considered the mental picture of a company or what springs into mind when hearing a company name or seeing the company logo (Gray and Balmer, 1998). However, there is some uncertainty as to how these two constructs interact with each other and with reputation. It is acknowledged that they are interrelated (Barnett et al, 2006), but it is less clear in which way.

For example, Chun and Davies (2001) suggest that reputation is the sum of identity (which is seen as the internal perception of employees) and the sum of images (the external view of customers). Formbrun (1996) regards reputation as the aggregate result of the many images stakeholders have of a company. However, Nguyen and Leblanc (2001, p 233) suggest that 'corporate reputation is an antecedent of corporate image' as both constructs are based on a

judgement whereby the former relates to a specific transaction and the latter is more a comparison with other companies.

Gotsi and Wilson (2001) differentiate reputation and corporate image in terms of time span. Whereas corporate reputation is an evaluation over a longer period, corporate image is more the daily judgement of company's behaviour or the images created by communication or symbols.

These considerations are contradictory to what was discussed in the previous sections where corporate reputation was seen as a judgement of past actions, corporate identity as how the company wants to be seen (e.g. an insurer with solid underwriting capabilities) and corporate image as how it is perceived by its various stakeholders. In that sense, corporate image should not be seen as an antecedent to corporate reputation as argued by Gotsi and Wilson (2001) as corporate image does not involve a process of judgements as in the case of corporate reputation

For Barnett et al (2006) there is a chain link between these components:

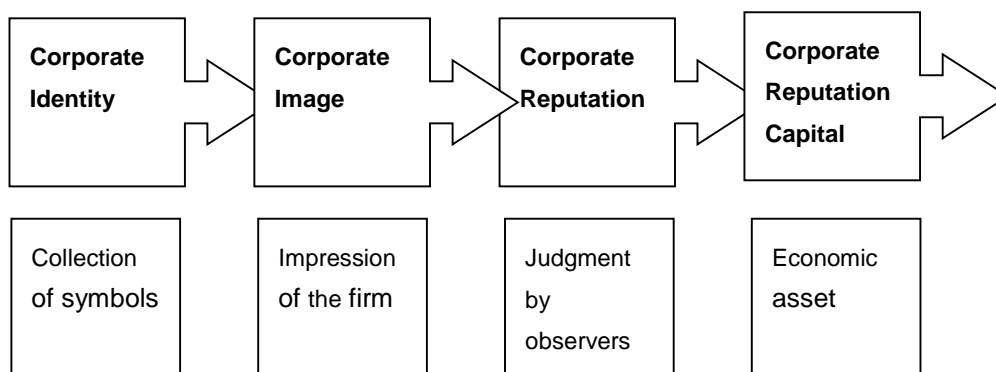


Figure 17 Chain link between identity, image and reputation (Source: Barnett et al 2006)

It could be construed that corporate image leads automatically to the built up of reputation. However, this would contradict the notion of a judgemental process necessary for the formation of reputation. In terms of the economic value of reputation, the suggestion of Barnett et al (2006) that reputation can help to accumulate an economic (intangible) asset appears to be plausible. According to Gray and Balmer (1998) the formation of corporate image and corporate reputation requires communication (by the organisation), which make sense for corporate image, whereas corporate reputation is experience related (either directly or indirectly) thus requires more than just communication.

In terms of corporate identity Gray and Balmer (1998, p 696) point out that identity refers to ‘what the organisation is’ and add that the principal components are the ‘company’s strategy, philosophy, culture and organisational design’. Following from this, an organisation will take actions (i.e. pursuing its strategy) which in turn will provide stakeholders with ammunition to evaluate the behaviour of a corporation which in turn should create (good or bad) reputation.

Based on the discussions above, the relationship between these three constructs is summarised in Figure 18:

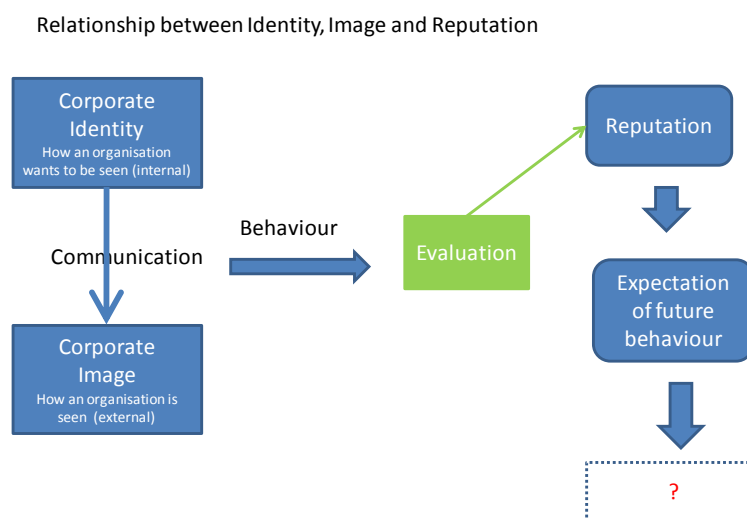


Figure 18 Relationship between corporate identity, image and reputation (own diagram)

The text box on the right side remains deliberately empty as this diagram will be gradually expanded in the following sections.

3.4 The importance of trust in the context of corporate reputation

Whilst the importance of trust is widely recognised, academic researchers continue to highlight the diversity of definitions of this concept. Mayer et al (1995, p 709) points out that ‘although a great deal of interest in trust has been expressed by scholars, its study [...] has remained problematic’. In particular, a ‘lack of clarity in the relationship between risk and trust; confusion between trust and its antecedents and outcomes [...]’ are observed. This leads Vogt (1997, p 60) to concede that trust remains a ‘chimeras character’. Blomqvist (1997, p 271) also acknowledges that there is ‘still a good deal of conceptual confusion’, which is partly due to poor conceptualisation. Blois (1999, p 197) points out that the discussion of trust has increased in recent years, but argues that ‘as might be anticipated, with such a central superficially obvious but essentially complex concept as trust, a diversity of views exists [...]’. On the other hand,

Moellering (2001, p 404) criticises current research on trust because it 'revolves around the functional properties of the concept' and adds that many researchers 'take the concept of trust for granted'. McEvily et al (2003, p 91) argue that 'empirical research on trust was not keeping pace with theoretical developments [...]'. In addition, the theory on trust in organisations - which is also relevant for this thesis - is 'not well integrated and that the literature as a whole lacks coherence' (McEvily, 2003 p 91). Ripperger (2003, p 35) agrees that there is plethora of definitions, but argues that paradoxically in day-to-day transactions trust is being utilised as a kind of "black box" whereby people assume that they know what trust means without being clear about it. The role of trust in every day (trans)actions has also been recognised by Luhman (2009) who sees it as an elementary requirement of daily life as without the existence of trust an individual would not even be able to get up in the morning.

It also appears that some research defines trust in a similar fashion as reputation or that academics attempt to define reputation, but use trust in the context of reputation without clarifying what they mean by trust. Furthermore, it is sometimes not clear whether there is a correlation between trust and reputation. However, where this correlation is acknowledged the mechanism is sometimes diffuse. Whilst Hosmer (1995) acknowledges that there is no agreement on a single definition, the author argues that work has not been wasted as it adds insight and understanding. It is also important to recognise that often the concepts of trust are used in different contexts. Notwithstanding this, Ripperger (2003) points out that trust is recognised as part and parcel of how human beings deal with each other and trust also drives our own behaviour.

There is also very limited research on potential connections between trust and reputation and often academics focus either on reputation or on trust. Scott and Walsham (2005, p 312) find it surprising that 'while the majority of literature on reputation may make some mention of risk, the discussion of trust is limited'. The next sections will explore the current thinking on trust and investigate the relationship between trust and reputation.

3.5 The concept of trust

Amongst others, Hosmer (1995) and Blomqvist (1997) attempted to categorise the different strands of school of thoughts on trust. Whilst the former tries to explain the concepts of trust in the context of organisational theories, the latter looked at the various approaches to trust by

academic disciplines (such as social psychology). Both mention Deutsch (1958) as one of the earlier researchers on social psychology. For Deutsch (1958, p 265) trust involves ‘the notion of motivational relevance as well as the notion of predictability’ which leads the author to define trust as follows: ‘An individual may be said to have trust in the occurrence of an event if he expects its occurrence and his expectations leads to behaviour which he perceives to have greater negative motivational consequences, if the expectation is not confirmed, than positive motivational consequence if it is not confirmed’ (Deutsch, 1958, p 266). Gambetta (2000, p 216) comes to a similar conclusion in the sense that trust requires a ‘particular level of the subjective probability with which an agent [...] will perform a particular action [...]’. What Gambetta (2000) also points out is that trust is particularly relevant under conditions of uncertainty.

Blois (1999, p 970) who examined the concept of trust in the context of business to business relationships emphasises the emotive element insofar as when one person betrays another person’s trusts there is a feeling of being ‘let down’ by the other party. This is a divergence from Deutsch (1958) and Gambetta (2000) who highlight the notion of predictability and probability, albeit a subjective one. However, the argument of Blois (1999) is partially in line with the concept of Lewis and Weigert (1985) of trust from a sociological perspective, whereby there is a differentiation between the cognitive and the emotional element of trust. In the former, ‘trust is based on a cognitive process which discriminates among persons and institutions that are trustworthy [...]. In this sense, [...] we base the choice on what take to be “good reasons”, constituting evidence of trustworthiness.’ (Lewis and Weigert, 1985, p 970). Adler (2001) offers a dissection of the notion of trust by how it is generated (sources and mechanisms) and by the targets of trusts which the author sub-classifies as objects and bases of trusts. Table 8 summarises Adler’s concept, although the dimensions and components of trust ignore that the potential interconnection of these categories. For example, direct interpersonal contact can contribute to reputation and vice versa.

Table 8 Dimensions and Components of Trust (Source: Adler, 2001)

Dimensions of Trust	Components of Trust
Sources	<ul style="list-style-type: none"> • Familiarity through repeated actions • Calculations based on interest • Norms that create predictability and trustworthiness
Mechanisms	<ul style="list-style-type: none"> • Direct interpersonal contact • Reputation • Institutional context
Objects	<ul style="list-style-type: none"> • Individuals • Systems

Dimensions of Trust	Components of Trust
	<ul style="list-style-type: none"> • Collectivities
Bases	<ul style="list-style-type: none"> • Consistency, Contractual Trust • Competence • Benevolence, loyalty, concern, goodwill, fiduciary trust • Honesty, Integrity • Openness

In respect of the emotional aspect of trust, Adler (2001, p 971) point out that this is complementary to the cognitive element; it is 'an emotional bond among those who participate in the relationship. This [...] is present in all types of trust, but it is normally most intense in close interpersonal relationships'. McAllister (1995) differentiates between affective and cognitive trust as a foundation for cooperation in organisations and highlights that cognitive trust is more based on the track record of a peer (i.e. past experience). Affective trust can be characterised by a greater investment of time and emotion. However, some level of cognitive trust may be necessary to develop 'affect-based trust' (McAllister, 1995 p30). Jones (1996) also emphasises the cognitive and affective elements of trust. In addition, for Jones (1996, p 7) trust is 'optimism about the goodwill and competence of another.'

3.6 Trust in economics

Since this thesis focuses on transactions between insurers and others stakeholders, trust in economics is the more relevant school of thought for the purpose of this research. Here Blomqvist (1997) argues that economists have not shown much interest in this concept mainly because they assumed an ideal market with absolute transparency, i.e. full information about all market participants, and pure competition. This ideal economic environment was challenged by the school of institutional economy which developed the concept of limited rationality (Furobotn and Richter, 1997).

Neo-classical economic theories presume the existence of a complete and transparent market and that only prices drive supply and demand. There is also an assumption that markets will reach equilibrium where the amounts of supply and demand are equal (Gillespie, 2007). Bittl (1997) therefore concludes that for the rational premise of complete markets, trust would be irrelevant.

However, the assumption of a complete and transparent market was challenged by the so-called Austrian school, amongst them Hayek and Schumpeter, which highlighted the importance of uncertainty in markets, the asymmetrical distribution of information amongst suppliers and buyers, and the dynamic nature of markets. Bittl (1997) argues that especially in microeconomic science where there is a more realistic view about the functioning of markets and where incomplete markets are assumed, trust comes strongly into play. The New Institutional Economics (NIE) theory tries to explain how institutions function in a market by extending classical economic assumptions. NIE assumes that decisions of institutions (i.e. firms) are made by individuals who behave differently when making decisions or different preferences (Furobotn and Richter, 1997).

NIE also expanded on the concept of transaction costs which was first introduced by Coase (1937). Transaction costs are related to information search about goods and services recognising that individuals need time and resources to gather information. This and the limited ability to process information, means that it might make sense for an individual to utilise heuristics (Fichtner, 2006) which are short-cuts for complex decisions (see section 4.2.2 for a further discussion).

The NIE sees a role for trust especially for transactions where uncertainty, risk or interdependency (i.e. where one transaction is reliant on another transaction e.g. selling a house in a chain) is predominant (Fichtner 2006). Incomplete markets and asymmetrical distribution of information result in market participants looking for mechanisms to reduce uncertainty, so that the expectations they have as regards contracts do actually materialise (Fichtner, 2006 and Ripperger, 2003). Adler (2001, p 219) believes that 'trust can dramatically reduce both transactions costs -replacing contracts with handshakes- and agency risks- replacing the fear of shirking and misrepresentation with mutual confidence.' Rossmann (2010) adds that because of the existence of trust in a business relationship, a consumer or business partner is able to reduce control and monitoring mechanisms which in turn helps to make business transactions more efficient.

Notwithstanding this, Bittl and Kremhelmer (2005) point out that although trust can reduce uncertainty, it does not eliminate the information deficit as expectations as to the actions of the trustee may not be fulfilled. Insofar, trust is only a form of risky advance. Bittl and Kremhelmer (2005) also regards trust as an information surrogate whereas this thesis considers reputation as such an information surrogate because trust is only created once an assessment of previous

actions has taken place and expectations of future behaviour (i.e. reputation) have been formed. Trust at some level is therefore a consequence of the built up of reputation.

Ripperger (2003) argues that because there is limited availability of information prior to a transaction, in most cases uncertainty results from it. This increases the complexity of transactions agreeing with Luhman (2009) that trust can therefore be used to reduce this complexity. Vogt (1997) sees uncertainty more in the context of the behaviour of others rather than uncertainty over an outcome and argues that if the transactional partners knew outcomes (in terms how they would behave) trust would not be necessary. Hence, every transaction requires trust because there is always an expectation of some degree of quid pro quo. This is similar to Bradach and Eccles (1989, p 104) who argue that 'trust is a type of expectation that alleviates the fear that one's exchange partner will act opportunistically'.

It could be argued that in economic transactions where written contracts are prevalent, trust is not needed or at least the need is significantly reduced as the fulfilment of obligations can be enforced by law, if necessary. However, Vogt (1997) points out that whilst this may be an option it can be quite costly and time consuming to do this, hence there is an incentive to use other instruments, such as trust. There is also the issue of uncertainty as to how courts would interpret the terms and conditions of a contract which increases the importance of trust as a means of reducing the risk of unwanted arguments about the interpretation of a contract. In this context, Ripperger (2003, p 49) emphasises that limited rationality means that contracts are always incomplete which means that behavioural risks can never be fully eliminated and 'in this sense, nearly all transactions contain an element of trust'. In addition, despite explicit contracts the coverage of all possible eventualities in a written document is nearly impossible, especially when it concerns complex business transactions. This leaves room for the interpretation of contractual clauses and hence different ways of dealing with it. Behavioural questions during the contractual relationship thus become more important. These can include issues, such as the timely payment of invoices or how a contractual partner deals with unsatisfactory services provided. Whilst unresolved contractual obligations can be brought to court, the time delay and costs can be crucial for businesses or individuals. If these obligations are not met in a timely fashion this could even lead to bankruptcy hence the important role trust plays even in contractual relationships.

Luhmann (2009, p 60) see trust as a means to 'reduce complexity' and argues that although organisations or individuals try to rationally plan, there is always an element of uncertainty as actions and its consequences cannot always be fully evaluated ex ante. Gigerenzer (2008) argues

that without trust an economy would not be able to survive and criticises the absence of the concept of trust in economic models. Moellering (2001, p 415) sees trust as 'a state of favourable expectations regarding other people's actions and intentions'. From a contractual perspective the expectations for the trustee or consumer is that the supplier can fulfil and is willing to fulfil a contract.

Ripperger (2003) differentiates trust and confidence in terms of expectations arguing that whilst confidence relates to the belief that an organisation is able to fulfil a contract, trust relates to the risk that a supplier misleads someone as to his ability to deliver. Trust is therefore associated with motivational aspects and behavioural risks. This distinction must be questioned because trust in the ability to deliver is not just a motivational issue; it is also a financial issue if companies run into financial difficulties. Fichtner (2006) also sees both the willingness and the ability to perform as components of trust. Mayer et al (1995, p 712) highlight that trust is also about 'the willingness of a party to be vulnerable to the actions of another party based on the expectations that the other will perform a particular action important to the trustor, regardless of the ability to monitor or control the other party.' Bittl (1997) adds that if there is no trust, corporations will lose (potential) buyers and over the long-term are likely to cease to exist. Noteboom (2005, p 37) point out that trust is 'associated with dependence and risk: the trustor depends on something or someone, the trustee or object of trust, and there is a possibility that expectations or hopes will not be satisfied, and that "things will go wrong". Trust entails the submission to relational risk. Yet one expects "things will go alright.' Ulaga and Eggert (2004) add that trust is an important part of business relationships as purchasing intentions are only translated into execution if there is trust between the supplier and the buyer.

3.7 Trust and Reputation

In Section 3.2.4 the judgemental nature of corporate reputation which creates an expectation about future behaviour is highlighted. Furthermore, it is argued that it is not clear whether there is a correlation between trust and reputation and if so, how these concepts are correlated. Adler (2001) acknowledges that one of the dimensions of trust can be reputation, but does not elaborate on the potential interlinkages between trust and reputation.

Kubon-Gilke et al (2005) argue that in order to understand the definition of trust, the modelling of reputation is important, as it explains the development of trust processes in an economic

environment. However, Kubon-Gilke et al (2005) question whether the creation of trust always requires the instrument of reputation or does reputation always create trustworthiness. However, this assumes that reputation always has positive connotation which is not the case. Reputation can have positive or negative parameters and can also result in mistrust thus leading to a negative decision by the transaction partners.

Dasgupta (2010, p 54), on the other hand, makes a case for reputation as a precursor for trust: 'You do not trust a person to do something merely because he says he will do it. You trust him because knowing what you know of this disposition, his information, his ability, his available options and their consequences, you expect he will choose to do it.' And further Dasgupta (2010, p 52) adds that 'trust is based on reputation and that reputation has ultimately to be acquired through behaviour over time in well- understood circumstances [...].'

Gaechter and Thoeni (2005) argue that one way to alleviate the problem of trust is reputation because the more information is available of past behaviour of a business partner the easier it will be to create trust and trustworthiness. More generally, Mojdeh Mohtashemi and Halberstadt (2002, p 288) posit that 'trust and reputation underlies every face-to-face trade' [...] and 'trading partners use each other's reputations to reduce this information asymmetry so as to facilitate trusting trading relationships.'

In principle, trust could be considered as a bridge to the final piece in signing a contract. Trust and reputation are therefore intertwined as trust can only be created through information about the intentions of the other party (Ripperger, 2003) and this can be provided in part through the reputation. In the context of information asymmetry Vogt (1997) argues that in order to reduce concerns about opportunistic exploitation in a transaction there needs to be information about the future behaviour of the other party. Reputation has a special role in this; it is the provider of information when it comes to the creation of trust or mistrust.

For Lewis and Weigert (1985) acting on trust involves a cognitive process as to whether individuals or institutions are trustworthy or should be distrusted. It could therefore be argued that this cognitive process is similar to the evaluation process which forms reputation; thus reputation can be considered as a precursor for trust.

Fichtner (2006) argues that there are two main elements of trust (or trustworthiness): The ability to perform and willingness to perform. These main elements comprise of a number of sub-elements which determine whether a party can be fully trusted. Therefore, trust is not only

about behavioural aspects, but also includes competences of an organisation or firm Figure 19 summarises the elements of trust:

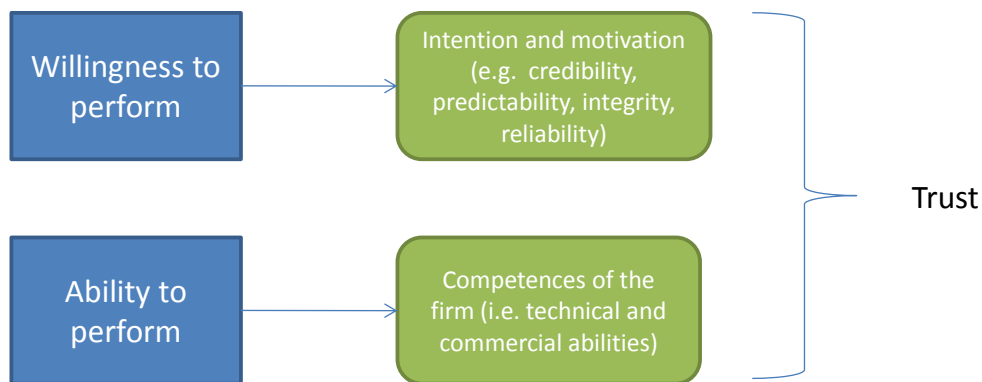


Figure 19 Elements of trust (based on Fichtner, 2006)

Trust is a precursor for making decisions under uncertainty as it provides the confidence that the organisation or individual will keep their promises. For Vogt (1997) the question is what carrier of information can reduce the information asymmetry between transaction partners, so that the fear of opportunistic behaviour does not prevent a transaction. For this purpose, reputation can contain information about the future behaviour of the transaction partner. As such, reputation can help to create trust, but also mistrust (Nguyen and Leblanc, 2001) if the evaluation process ends up with a negative judgement. Reputation contains information about previous behaviour which enables a party to transaction to extrapolate expectation of future behaviour. It helps consumers to judge whether they can trust an individual or an organisation to do what the consumer expects of them, i.e. being able and willing to perform a contract. Thus, Reputation can be seen as a support mechanism for trust as it increases the perceived reliability of individuals or organisations (Kubon-Gilke, 2005).

Based on the above deliberations, Figure 20 can be extended to include the trust element:

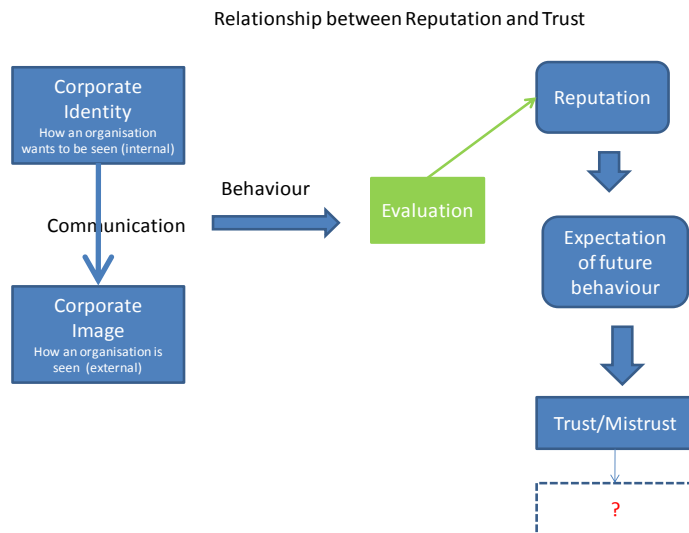


Figure 20 Relationship between reputation and trust (own diagram)

Notwithstanding the support mechanism of reputation and trust, the risk of unexpected behaviour remains. Vogt (1997) highlights that whilst expectations can be created based on existing information, an absolute rational prognosis about the other party's behaviour, during a contractual period, is impossible. Lewis and Weigert (1985) also argue that knowledge about previous experience can never fully explain the creation of trust. There is an element of leaping into uncertainty which enables individuals or organisations to make decisions. Vogt (1997) adds that trust implies that there is uncertainty about whether one should behave in a certain way because the outcome of such behaviour is dependent on how the other partner in a transaction behaves. Behaviour in Vogt's (1997) sense means making a decision about whether or not to enter into a transaction.

Helm (2007) points out that reputation can function as a sanction mechanism which creates an incentive for an organisation to conduct business in the expected (promised) way. It is only the threat of a damaged reputation which makes a firm think twice before breaking a contract or an agreement. Gaechter and Thoeni (2005) argue in similar manner insofar as where the behaviour of a party has an impact on reputation, the chances of the fulfilment of trust (in the sense of a reduced risk of opportunistic behaviour) are significantly higher. This in turn helps a consumer to have trust in the ability and willingness to perform. Vogt (1997) makes clear that a non-opportunistic behaviour is expected from partners in a trustworthy business relationship. However, this does not mean that the business partners suddenly turn into altruistic actors; the egoistic motives (i.e. to conclude a transaction) of these business partners still remain.

Fichtner (2006) believes that the expectations which are formed through the reputation process become concrete when trust is being shaped. Helm (2007) also points out that reputation is not only necessary for creating trust, but that trust can also reinforce reputation when expectations have been met i.e. when a transaction was successfully concluded, for example an insurance claim has been paid. Marsh (2002) emphasises the role of reputation and trust in reciprocal exchange as reputation and trust can help to overcome the problem of finding partners, including business partners, who individuals can trust. One way of reducing time efforts to find trustworthy individuals is to stick to familiar members of a group, such as brokers or underwriters people have already dealt with. This 'can increase the chances of knowing a person's reputation, and provides some security in that violations of trust may be damaging to reputation.' (Marsh, 2002 p 54) Meyer (2012, p 42) posits that 'reputational information supports trust and reduces opportunism in economic transactions.' Spremann (1988) highlights the catalytic effect of reputation, especially in financing, and argues that the more there is uncertainty about the quality of a product the more important becomes reputation. The reputational actions of an enterprise can help to increase the trustworthiness of a company.

The final element once trust or mistrust has been established is a decision which can be positive or negative. As such Figure 20 as shown above can now be completed (Figure 21):

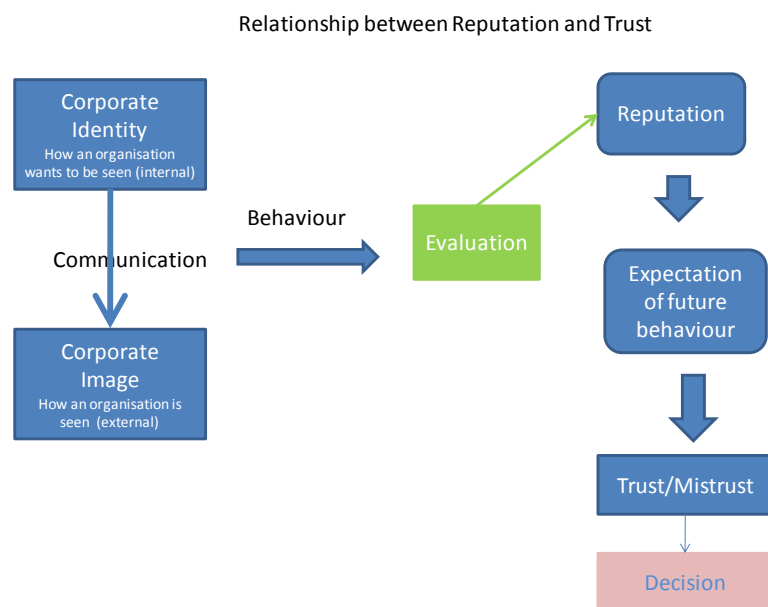


Figure 21 Relationship between reputation trust and decisions (own diagram)

3.8 Corporate Reputation and its Relevance for Insurance Buying

In general, there is a difference between the purchase of insurance and the purchase of manufactured goods, such as a car, mainly because of ability or inability to evaluate the product prior to the purchase. Alchian and Woodward (1988) offer a categorisation of products by how the purchasing process is transacted and come up with two classifications:

Exchange and Contracts:

The main distinction is whether the object exists before an agreement is reached (e.g. washing machine) or whether this will only become evident after the agreement was signed or concluded. An exchange is thus 'a transfer of property rights to resources that involves no promises or latent future responsibility' (Alchian and Woodward, 1988 p 66). On the other hand, a contract 'promises future performances, typically because one party makes an investment, the profitability of which depends on the other's party future behaviour' (Alchian and Woodward, 1988 p 66)

Weiber and Adler (1995) highlight that during the transaction of exchange goods, the attributes of this product are already existent prior to the conclusion of a contract. However, uncertainty revolves around the question whether the product allows the expected functions and has the quality as set out in the contract. The transactional process for contract goods involves the promise of future performance. Whereas the ability to perform is in the short-term certain, there is a significant uncertainty whether the supplier, for an example, an insurer, will continue to do so in the future and whether the supplier is willing to do so (Weiber and Adler, 1995). The congruence between the attributes of a product or service and the actual outcome cannot be tested hence are highly dependent on the subjective perception of the consumer. The client will evaluate within his/her own framework whether expectations have been met and whether the result is in line with his/her own attitude and individual value system.

Table 9 Differentiation of performance attributes of goods (Source: Adler and Weiber, 1995)

		Timing of Evaluation of Product Attributes	
		Prior to purchase	After purchase
Ability to evaluate performance attributes	Possible	Search attributes	Experience attributes
	Not possible	Experience or trust attributes	Trust attributes

Weiber and Adler (1995) summarise their findings in Table 9. The main issue is whether potential buyers are able to evaluate the performance attributes of a product prior to a purchase. For example, a buyer of a new car can check the attributes of the product at a car dealer, including the model, the colour and extras, whereas a buyer of services, such as insurance, has to rely on the promise of the seller that the product attributes are realistic, such as a speedy claims settlement. Weiber and Adler (1995) also conclude that where product attributes cannot be evaluated prior to the purchase trust or previous experiences with the supplier are an important factor in purchasing decisions.

In terms of purchasing decisions, Solomon (2006) sees them as a response to a problem which requires a number of steps prior to buying a product. These steps consist of problem recognition, information search, and evaluation of alternatives, product choice and decision making. The literature on purchasing behaviour assumes that, in principle, private consumer and commercial consumers will have varying degrees of rationality when making decisions. However, Solomon (2006) argue that as decisions are made by individuals, even purchases for business purposes, other non-rational behavioural and motivational factors will play a role. Mantel Powell and Kardes (1999) argue that depending on the motivation of the buyer and the information available there will either be a focus on specific attributes of the products or on general attitudes, impressions, intuitions and heuristics. Heuristics or general attitudes can help to simplify a purchase. Feldman and Lynch (1998) point out that for making decisions easier, existing memorised attitude and judgement are being utilised rather than generating new information. Eberl (2006) argues that corporate reputation can be seen as such a memorised attitude which can be retrieved if needed. Feldman and Lynch (1988) also argue that there is an even stronger correlation between attitude and behaviour when the consumer had previous direct experience with the corporation, i.e. when the person was able to form a judgement.

The judgement and the formation of expectation of future behaviour by a corporation (in the form of reputation) can then influence how consumers evaluate the attributes of a product, which are offered by a firm (Eberl, 2006). Meyer (2012) emphasises that regardless of whether economic transactions involve large deals or just the daily shopping at the supermarket the buyer of products or services always faces an information problem. This is because the buyers cannot be certain that the product or service he/she wishes to obtain has the either the expected attributes or the supplier behaves in a manner commensurate with what is expected from him/her. Reputation can help to reduce information asymmetries. Shapiro (1983) argues

that when buyers make purchasing decisions, warranties provided by the seller are normally limited to a certain period, for example one year. However, buyers of, for example washing machines, will have certain expectations about the durability of the product, depending on the reputation of the manufacturer and hence reputation functions as a kind of guarantee well beyond the warranty period. Spremann (1988) sees an important role for reputation in the agent/principal relationships. The author uses the term punishment rather than sanction in this context, although in effect the outcome is similar. More importantly, Spremann (1988) indicates that in order for this punishment to be effective the agent needs to be in a position to be punished, such as through the loss of business. In that sense the agent provides collateral to the principal and if this asset reputation gets damaged his or her business might suffer. Bueschken (1988) is clearer about this specific function by highlighting that reputation is an instrument to reduce uncertainty only if there is credible threat that opportunistic behaviour (by the agent) will result in a damage to reputation and hence to economic losses through the communication of such a behaviour by consumer and the subsequent abstinence of other consumer who become aware of such behaviour.

3.9 The role of reputation and trust for insurance

The concept of insurance is discussed in section 2.2. Due to the intangibility of insurance one would expect reputation to play a more important role than for other industries. Herger (2006) argue that reputation and reputation management are critical in the insurance industry because of the long-term relationship with clients. Wiedmann (2005) points out that because insurers are providing cover for an increased number of risks, reputation is an important, especially when it comes to the perception whether an insurer will still be around in the future to pay claims. This and the ability, as well as the willingness, of an insurer to pay claims can only be signalled rather than actually proven when a contract is concluded. Based on the categorisation of Weiber and Adler (1985) insurance products fall into the category where the ability to evaluate performance attributes is not possible prior to a purchase (see previous section); hence other signalling functions, such as reputation and trust, are required to facilitate the purchase. Schanz (2009, p 262) adds that 'it is undisputed that trust is an indispensable ingredient of insurance business. [...] From a policyholder's perspective the insurer's willingness and ability to fulfil these promises cannot be assessed until claim has been filed and settled. [...] Information asymmetries make it difficult for policyholders to instantly judge and assess the value of an insurer's promise

to pay. Where this occurs, the reputation, performance, accountability and appearance of an insurance company are instrumental in generating trust with policyholders.’ Wiedmann et al (2009) agrees that the interaction between market participants is based on incomplete information thus creates uncertainty amongst individuals, such as policyholders or brokers. It is therefore necessary to reduce this uncertainty either through the reduction of the information deficit or by increasing trust through a better reputation. As a result, reputation is an information instrument which stabilises the behaviour of market participants and thus improves market efficiency.

The question whether there are differences in the drivers of reputation by industry segment was explored by Schwaiger and Eberl (2004). The authors argue that because the quality of the product is not visible at the time of purchase research into whether reputation has a specific signalling function is particularly important for insurance. To investigate whether reputation plays a more important role in the insurance industry, 1717 telephone-based interviews were conducted amongst randomly chosen households in Germany, the UK and the United States. The interviewees were asked to evaluate four insurance companies based on six main criteria, sympathy, competence, attractiveness, responsibility, performance and quality on a 1 to 7 rating scale.

Based on the analysis of interviews, they concluded that there is no difference as regards the importance of the driver “attractiveness” compared with other industries. However, they observed that for the drivers “responsibility”, “performance” and “quality” results can vary significantly. Especially the sub-categories “not only profit is important” (as part of responsibility), service offerings and client focus (as part of quality) highlighted noteworthy divergent results. Another conclusion is that performance and quality play a major role for reputation. In addition, there was a strong correlation between the more cognitive element, performance, and the affective element sympathy. It was found that this correlation cannot be seen in other industry segments.

Eberl (2006) concluded that reputation plays a more limited role when product attributes are available, but it becomes more important where it is difficult to find or verify the product attributes, such as insurance. Wiedmann et al (2009, p 22) claim that reputation can work as a guarantee signal which in turn helps to reduce the risk for the consumer and which applies in particular to the ‘trust product insurance.’ Eberl (2006) slightly contradicts this as the author does not see reputation as an either or principle, but rather as embedded in the range of information available to make a purchasing decision.

In respect of trust, Schanz (2006 p 377) claims that 'insurers are in the business of trust' as they sell contingent promises. Trust is therefore 'a necessary condition for conduction business' (Schanz, 2006 p 378). Because of the nature of Insurance transactions there is a higher uncertainty that the seller (insurer) will fulfil the contractual obligations, compared to other purchases. Trust can therefore help to overcome uncertainty prior to a transaction. Trust in the ability, motivation and product quality can influence the choice of supplier (Fichtner 2006). Spreman (1988) emphasises that especially in the insurance industry the ability to generate trust through a positive reputation is an important function.

Alchian and Woodward (1988) also argue that uncertainty and trust play an even more important role for 'contract goods' where the future performance cannot be tested, such as investment plans or insurance contracts. Such contracts are based on a promise to perform (either paying out a guaranteed rate or paying an insurance claim) and such a promise is not evident prior to completing a contract and which does depend on the future behaviour of a supplier or service provider. (Alchian and Woodward, 1988) Adler (2001 p 218) highlights the importance of trust in an 'anonymous' system, such as money and law, of which insurance is part of. Trust is a necessary element for insurance contracts as the policyholder cannot know for sure whether the insurance company will be still around when a claim occurs and whether the insurer will pay in accordance with the policy.

The ability to build up trust through reputation can be turned into a competitive advantage. However, this can easily be damaged if insurers inflate their assets or have to restate their earnings or show accounting irregularities (Zboron, 2006). Bittl (1997) argues that insurance buyers only have a limited ability to assess the product prior to or after signing a contract. In addition, some insurance products, such as life insurance, have a relatively long duration and create even more uncertainty for the policyholder, hence require an increased trust in the supplier.

3.10 Conclusion

The objective of this chapter was to explore the concepts of reputation and trust, what role these concepts might play in business decisions and whether there is more specific role for reputation and trust in the insurance sector. The main findings of this chapter are summarised as follows:

- For both concepts there is wide array of definitions which has partially to do with different strands of academic research, such marketing, economics and psychology. However, based on the discussions, this thesis sees corporate reputation as a judgement about past actions of individual or organisations which in turn creates expectations about the future behaviour of individual or organisations. Where there is no direct experience of past actions, stakeholders will be informed through media or other channels. The judgemental or evaluation feature of reputation is supported by a number of authors (for example, Gotsi and Wilson, 2001, Barnett et al, 2006, Baden-Fuller et al, 2000) and future expectation feature is supported by Mahon (2002), Formbrun (1996) and also Yoon (1993) in respect of product quality. Reputation is also different from corporate image and corporate identity as the former is how a company is seen by its stakeholders (Barnett et al, 2006) and the latter how an organisation wants to be seen in the public (Luhmann, 2000).
- In respect of trust, some of the earliest research is from Deutsch (1958) who emphasised the notion of predictability of certain behaviour of the other party who is trusted. Gambetta (2000) also highlights that trust is about the probability than an agent will perform certain actions. More importantly, Gambetta (2000) considers trust as particularly relevant under conditions of uncertainty. Luhmann (2009) argues that trust is needed to reduce the complexity of decision making because it limits uncertainty about the outcome of decisions.

From an economical perspective, the New Institutional Economics (NIE) sees a particular role for trust where uncertainty, risk or interdependency are predominant. In addition, trust can significantly reduce transaction costs because trust creates mutual confidence that parties to an agreement will fulfil their obligation (Adler, 2001).

- In respect of the correlation between reputation and trust there is no clear picture emerging, partially because reputation and trust are sometimes used interchangeably as a judgement of previous behaviour. However, this thesis argues that trust is a precursor for making decisions under uncertainty because it provides confidence that an organisation or individual will keep their promises. This is supported by Dasgupta (2010) and Gaechter and Thoeni (2005) who see reputation as the information provider which in turn can produce trust. In addition, Kubon-Gilke (2005) argues that reputation can be seen as a support mechanism for trust. Marsh (2002) is also explicit about the correlation between reputation and trust by arguing that one of the ways to reduce the

time and effort to find trustworthy individuals is to do business with individuals who you have already dealt with. This is because their reputation is already known and these individuals will be aware of their reputation. In addition, these individuals will be concerned that a violation of trust will negatively impact their reputation.

- Concerning a specific role of reputation and trust in the insurance sector Herger (2006) and Wiedmann (2005) see reputation as an important factor either because of the long-term relationship with a client or because of the signal function of reputation relating to the ability and willingness of an insurer to pay future claims. Schanz (2009) highlights that trust is part and parcel of insurance business because of information asymmetries about the future behaviour of insurers. In addition, reputation can help to generate trust with policyholders.

In short, reputation is a judgment about previous behaviour which creates expectations about future behaviour. This evaluation in turn helps to either create trust or mistrust. Trust can help to reduce the complexity of decisions especially under conditions of uncertainty and there is a specific role for reputation and trust in the insurance sector because of the intangibility of the product 'insurance'.

4 Overview of existing concepts of behavioural decision theories

4.1 Introduction

In the previous chapter, it was concluded that reputation and trust are necessary precursors for decision making where one party expects an action from the other party, such as concluding an insurance contract. This is because reputation and trust enables parties to an insurance contract to be more confident about the outcome of such expectations, and hence allows clients, brokers and underwriters to be confident about a decision they intend to make (which can either be positive or negative). Furthermore, corporate reputation is formed when individuals assess the actions of others and form a view as to their ability to achieve what they promise. Management actions are the result of a decision making process, either individually or collectively, which lead to wanted or unwanted outcomes. This means that there is a causal link between reputation and the decisions/behaviours of underwriters as well as broker. The reputation formed through evaluation of these decisions enables others to trust or mistrust these market participants. Figure 22 illustrates the interdependencies between reputation, trust and decision making:

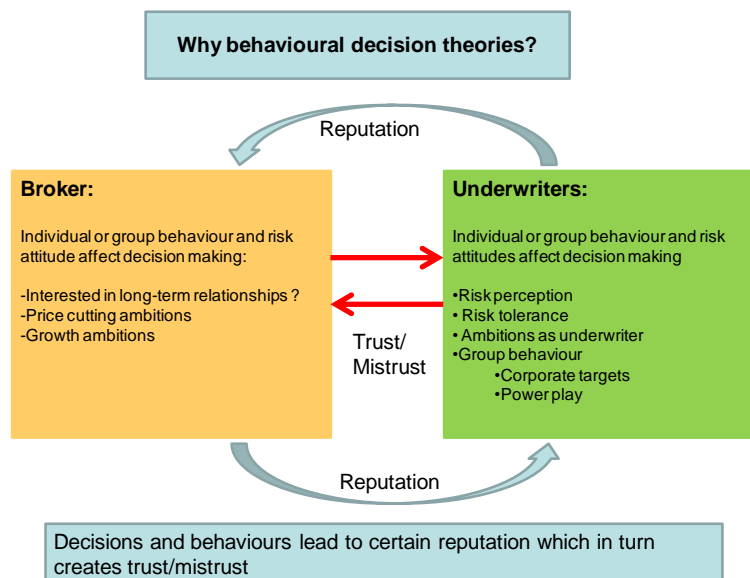


Figure 22 Why behavioural decision theories? (own diagram)

Regardless of the nature of decisions the management of any corporation faces, these decisions will reach into the future thus carrying uncertainties about the final outcome, however well planned they might have been. In this context, Kopfsguter (1998) argues that complex systems, such as corporations, need to make decisions on a daily basis, which not only carry the risk of an

unexpected outcome, but also the risk that even if the outcome is expected, some stakeholders may not be satisfied about the outcome. Underwriters in the London insurance market have to make daily decisions about whether to provide insurance cover or not. These are economic transactions which carry an element of risk, and therefore the concepts of decision making under uncertainty are relevant in this context.

The main objectives of this chapter are as follows:

1. To explore why the notion of rationality in normative economic decision theories has been challenged by behaviour or descriptive decision theories;
2. To investigate the inherent uncertain nature of decisions;
3. To introduce some relevant concepts of decisions theory which might be relevant for insurance decisions.

The starting point is an introduction to descriptive theories and what decision making involves. This is followed by an overview of three decision concepts, namely heuristics and biases, the influence of emotions and affects and dual-processes. Furthermore, neurological research on the behavioural impact of affect and emotions, decision making by managers and group decisions, will be introduced. There will also be a discussion on whether reputation and trust could be considered as heuristics. The last two sections deal with two reports published by Lloyd's of London on decisions theories and risk perception.

4.2 Descriptive (behavioural) decision theory

The paradigmatic considerations in respect of descriptive decision making theories stem from Simon (1957) who introduced the concept of 'bounded rationality'. This was a move away from the notion that human beings will always act rationally when it comes to economic decisions (*homo economicus*) which is embedded in the idea of complete and transparent markets and competition. Simon (1957) acknowledged the cognitive limitations of individuals and cast doubt over normative assumptions about the behaviour of individuals. Indeed, Simon (1957, p 81) questioned the idea of rationality:

1. 'Rationality requires a complete knowledge and anticipation of the consequences that will follow on each choice. In fact, knowledge of consequences is always fragmentary.

2. Since these consequences lie in the future, imagination must supply the lack of experienced feeling in attaching value to them. But values can be only imperfectly anticipated.
3. Rationality requires a choice among all possible alternative behaviours. In actual behaviour, only a very few of all these possible alternatives come to mind.'

And concluding on the argument of the limits of rationality, Simon (1957, p 241) posits that 'rationality, then does not determine behaviour. Within the area of rationality behaviour is perfectly flexible and adaptable to abilities, goals and knowledge. Instead, behaviour is determined by irrational and non-rational elements that bound the area of rationality.'

More recent authors have also argued along the same lines. Pohl (2004, p 1) cites Cicero's famous words "Errare humanum est." (116-43 BC) and asserts that 'humans do make errors in thinking, judgement, and memory is undisputed' which led to a move away from the concept of pure rational human being. Selten (2002, p 13) adds that 'modern mainstream economic theory is largely based on an unrealistic picture of human decision making. Economic agents are portrayed as fully rational Bayesian maximisers of subjective utility.' Gigerenzer (2002, p 38) also points out that 'humans and animals make inferences about unknown features of their world under constraints of limited time, limited knowledge, and limited computational capacities. Models of rational decision making in economics, cognitive science, biology, and other fields, in contrast, tend to ignore these constraints and treat the mind as Laplacean⁶ super intelligence equipped with unlimited resources of time, information, and computational might.'

4.2.1 Decisions

Mittlerlechner (2007, p 46) regards decisions as the 'basic operation of an organisation' and 'a decision makes a difference by selecting an alternative from the world'. The word world is interchangeably used with the word environment in which the organisation operates. This could be interpreted as if organisations have to deal with only one alternative when making a decision. However, most organisations or individuals are faced with a multitude (and sometimes infinite) of alternatives when making decisions. For Luhmann (2000) decisions within organisations are concerned with information processing, but also communication of what these organisations have decided. Organisations are social systems which create decisions and these decisions

⁶ From Pierre-Simon marquis de Laplace, 1749 – 1827, French mathematician and astronomer

trigger further decisions. As such these organisations reproduce themselves on the basis of these decisions and are therefore autopoietic or self-organising systems (Seidl, 2004).

Farny (1995) emphasises the inherent uncertain nature of economic decisions of individuals (in organisations). The behaviour of economic actors does normally not yield one clear outcome. Indeed, these actions can yield a multitude of outcomes, albeit the probability of such outcomes may differ. What Farny (1995) also emphasises is that the environment in which individuals or organisations operate can influence possible outcomes thus increases uncertainty. Figure 23 highlights the inherent uncertainty of economic decisions hence explains why ‘the rationally concept championed by expected utility theory is empirically questionable if not false [...]’ (Mitterlechner, 2007) For Luhmann (2000), uncertainty surrounding decisions is created because simultaneously there is knowledge and non-knowledge which the individual or organisation has to deal with.

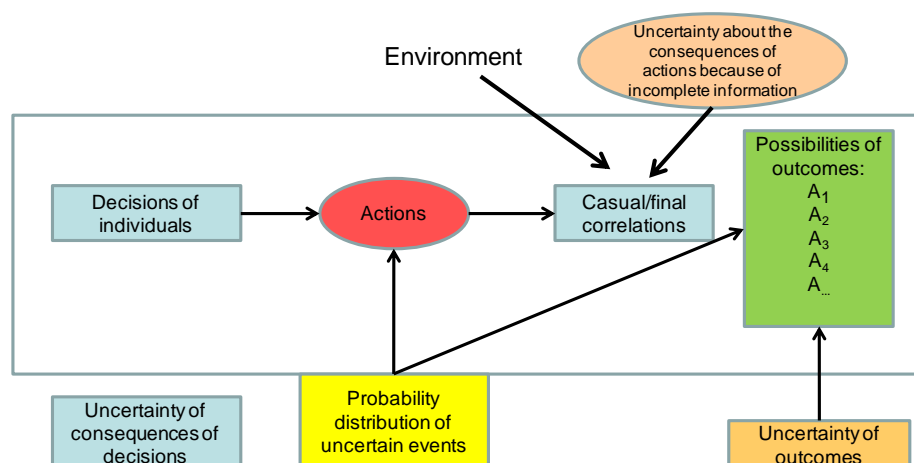


Figure 23 Decision flow and uncertainty (based on Farny, 1995)

For Jungermann et al (2005) decisions are processes which consist of judgements and choices whereby an individual has at least two options from which he/she can choose or where an individual realises that an existing situation is not acceptable and is looking to change this by searching for other options to arrive at a desirable situation. Jungermann et al (2005) also highlight that uncertainty means that the consequences of the decision options are dependent on non-controllable external events, such as the behaviour of others.

4.2.2 Heuristics and biases in decision making

The principal work on cognitive processes when making decisions under uncertainty was developed by Tversky and Kahnemann (1974) who concluded that if individuals have to assess the probability of an uncertain event happening they rely on 'heuristics' in order to reduce the complexity of decision making, especially when there is an information deficit (i.e. uncertainty). Tversky and Kahnemann (1974, p 1124) regard heuristics as a means to 'reduce the complex tasks of assessing probabilities and predicting values to simpler judgemental operations.' The authors identified three main heuristics:

- Representativeness:
- Availability:
- Adjustment and anchoring:

Representativeness refers to individuals making assumptions about the probability of an event by the similarity of the sample in relation to the overall population.

Availability refers to the assessment of the frequency of events depending on how easily information can be retrieved.

Adjustment and Anchoring refers to the fact that individuals use previous experience (either positive or negative) to make judgements about probabilities.

Marsh (2002, p 49) expands the concepts of heuristics and sees them as 'cognitive shortcuts that enable individuals to make evaluations on the basis of one or a few simple rules or cues, thereby avoiding the processing and time costs related to exploring an exhaustive set of possibilities.' Whilst heuristics, which Schwenk (1988, p 43) considers as 'rules-of-thumb', can be an efficient mechanism to make decisions, they can also lead to biases thus errors in judgments (Bottom, 2004). Notwithstanding this, Marsh (2002, p 55) points out that 'while some heuristics may occasionally lead to poor inferences, they may produce generally accurate inferences using a fraction of the time and effort that would otherwise be necessary if options were to be conserved more carefully.' Gigerenzer (1991, p 22) also challenged the concept of biases as juxtaposition to heuristics and claims these biases are 'in fact not violations of probability theory', because the assumption that statistical problems, such as the probability of floods happening, have only one precise answer is incorrect.

Kahneman and Tversky (1996, p 589) refuted this argument by claiming that Gigerenzer 'underplays the importance of subjective probability; he also believes that subjective probabilities can be explained in terms of learned frequencies.' Indeed, errors or biases are

especially prevalent where statistical data is readily available. Furthermore, 'subjective judgements of probability are important because action is often based on beliefs regarding single events' (Kahneman and Tversky, 1996, p 589). Martin and Bartscher (1993) agree that individuals make errors in judgement because, inter alia, of different perceptions of risks and the difficulties in interpreting the outcome of decisions which may lead to wrong conclusions for future (similar) events. Kirsch (1998, p19) believes that if an individual exceeds this capacity to absorb information he/she suffers from 'cognitive stress' and consequently, individuals try to use mechanisms to reduce this stress, such as heuristics, but also highlights that muddling through is part of daily life.

Gigerenzer and Gaissmaier (2011, p 454) offer a broader and more optimistic definition of heuristics: 'A heuristic is a strategy that ignores part of the information, with the goal of making decisions more quickly frugally, and/or accurately than more complex methods.' This definition also challenges the notion that heuristics can lead to greater errors or biases in decision making. Indeed, Gigerenzer and Gaissmaier (2011, p 453) posit that 'when heuristics were formalised, a surprising discovery was made. In a number of large worlds, simple heuristics were more accurate than standard statistical methods that have the same or more information.' Furthermore they conclude that 'a heuristic is not good or bad, rational or irrational; its accuracy depends on the structure of the environment [...]' (p 474) Harvey (1998, p 49) adds that the use of heuristics is also influenced by the way individuals see the world as 'there does not exist an objective "reality" around us, from which data for our decision-making processes can be harvested. Instead, we rely on subjective, culturally specific *interpretations*⁷ on the sensory information our biological selves have collected.' Harvey (1998) also argues that how Europeans and people in the United States understand the world may be more 'conducive to the use of heuristics than (for instance) expected-utility calculations,' although the author caveats this by highlighting that most research relating to heuristics stems from the aforementioned territories which limits its automatic extension to other markets. Concluding on this theme and similar to Gigerenzer and Gaissmaier (2011), Harvey (1998, p 50) posits that 'decisions guided by heuristics may be made soundly and profitably time and time again, and while there is no guarantee that people relying on heuristics will learn from past mistakes and correct their errors, it is certainly possible.'

⁷ Italics by author

4.2.3 The influence of emotions and affects on decision making

In the previous section, it was argued that individuals find it difficult to make rational decisions due to cognitive limitations. Hence individuals use heuristics in order to reduce the complexity of decision making. However, academic research is increasingly focusing on emotional or affective factors which might influence decision behaviour. In particular, Slovic et al (2004) argue that more attention should be directed towards this issue. The authors also suggest that in extension to three main heuristics formulated by Tversky and Kahneman (1974), 'affect' should be in the same category. Affect is defined by the authors a 'specific quality of "goodness" or "badness" (i) experienced as a feeling state (with or without consciousness) and (ii) demarcating a positive or negative quality of stimulus.' (Slovic et al 2004, p 312)

An early proponent of such a notion was Zajonc (1980, p 1) who believes that individuals' first reaction is very often affective rather than cognitive as 'affective reactions can occur without extensive perceptual and cognitive encoding, are made with greater confidence than cognitive judgments, can be made sooner.' In terms of perceptions Zajonc (1980) goes further and argues that all perceptions contain some affect.

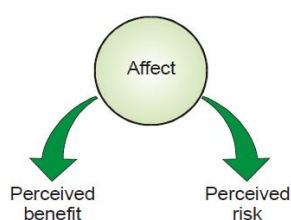


Figure 24 Affective behaviour (Source: Slovic et al, 2004)

Slovic et al (2004, p 314) presume that all images in the memory of an individual are marked with affects and conclude that 'using an overall, readily available affective impression can be easier and more efficient than weighting the pros and cons of various reasons or retrieving relevant examples from memory, especially when the required judgment or decision is complex or mental resources are limited.' The authors accept that there are downsides to affect heuristics, mainly that it can lead to wrong decisions. This is in line with Tversky and Kahneman's (1974) general argument about the potential for biases when utilising heuristics. For example,

affective reactions are susceptible to manipulation by others. In addition, where the potential outcome of decisions relates to visceral factors, such as fear, the affective behaviour is sometimes difficult to anticipate.

Shiv et al (2005, p 438) also emphasise the role of emotions in complex decisions because emotions are easier available than cognitive judgements, although these emotions can also be disruptive: 'The automatic emotions triggered by a given situation help the normal decision making process by narrowing down the options for actions, by either discarding those that are dangerous or endorsing those that are advantageous. Emotions serve an adaptive role speeding up the decision making process. [...] Depending on the circumstances, moods and emotions can play useful as well as disruptive roles in decision making.' Disruptive in the sense that decisions which are highly influenced by emotions may turn to be totally wrong when they are reviewed in a more cognitive or deliberate fashion.

4.2.4 Dual-process theory

Whilst Slovic et al (2004) and Zajonc (1980) emphasise the role of affect in decision making, other researchers emphasise that a combination of cognitive and affective factors drive decision making. This so-called 'dual process theories' accept that affective and cognitive behaviour cannot be separated. Amongst the proponents is Epstein (1994, p 710) who points out that 'there is no dearth of evidence in every-day life that people apprehend reality in two fundamentally different ways, one variously labelled intuitive, automatic, natural, non-verbal, narrative, and experimental and the other analytical, deliberative, verbal and rational.'

Epstein (1994) also argues that affective judgements are normally faster available and in certain situations, such as a life threatening event, this helps to make speedy decisions. However, most people are aware of the two ways of information processing (i.e. cognitive and affective) and depending on the situation, one or the other will more strongly influence the judgement or decision. Stanovich and West (2000) use different terminologies for a similar approach, namely System 1 and System 2 processes. 'System 1 refers to characterized as automatic, largely unconscious, and relatively undemanding of computational capacity. [...] System 2 encompasses the processes of analytic intelligence that have traditionally been studied by information processing' (Stanovich and West, 2000, p 658). However, more recently Evans and Stanovich (2013) argued that using the System 1 and System 2 terminology might be misleading as they

actually refer to decision processes rather than one single step. Consequently, Evans and Stanovich (2013) promote the use of terms Type 1 and Type 2 whereby Type 1 refers to intuitive processes and Type 2 to reflective decision processes.

Loewenstein and O'Donoghue (2005, p 1) define the 'dual process' as a deliberate process (which is similar to the cognitive process) 'that assess options with a broad, goal based perspective', and an affective process 'that encompass emotions and motivational drives.' In addition, Loewenstein and O'Donoghue (2005) introduce the concept of 'willpower' which they see as the ability to control affective influences. Whereas other authors, such as Slovic et al (2004) argue that emotions or affection influences decisions, Loewenstein and O'Donoghue (2005) believe that the interplay between affective and deliberative systems will depend on environmental stimuli, such as anger. Such stimuli might arise when a manager is under pressure to respond to a crisis situation, such as the oil spill in the Gulf of Mexico in April 2010 which the BP management had to deal with. This concept could be applied to insurance underwriting where underwriters are very often under pressure to accept price reduction in order to retain an important client or account, especially during a soft market cycle (see section 2.3.2). In such situations the affective system might be more dominant thus overruling the cognitive system. Moreover, Loewenstein and O'Donoghue (2005) argue that the influence of affection can be overridden through willpower, but it appears there is no clear concept how exerting such a control would work in reality. On the other hand, the authors appear to accept that willpower is in short supply and that in particular in stress situation, such as mentioned above, affection has a much stronger influence than cognition.

Loewenstein et al (2001) suggest that the discrepancy between cognitive and emotional reactions of individuals is based on the fact that the evaluation of risks is cognitive whereas the reaction to risks is emotional. Whilst cognitive decision making follows the typically variables of the decision theory, such as probabilities, affective decisions are very often driven by associations and fear.

4.2.5 Neurological research on the behavioural impact of affect and emotion

Affect and emotion are very much linked to brain functions and neurological research is increasingly recognising the role these elements play in decision making. One of the ground breaking research was conducted by Damasio (1994) who, based on a number of studies, came

to the conclusion that so-called 'somatic markers' influence the decision making process. These markers are 'feelings generated from secondary emotions. These emotions and feelings have been connected, by learning, to predicted future outcomes of certain scenarios' (Damasio, 1994, p 174). The assumptions behind this hypothesis are:

- The human thinking and decision processes are dependent on a number of neural operations, of which some are deliberate and cognitive.
- Deliberate and openly cognitive operations are based on sensory images which in turn are based on the activities of sensory cortex and which are relatively old when looking at evolutionary history.
- These cognitive operations are dependent on supportive processes, such as attention, memory and emotions.
- The thinking and decision processes are influenced by the availability of knowledge about situations, actors, options and consequences which are memorised in the cortex. This knowledge can be called upon through motor reflexes or images.

For example, when a positive marker is associated with a certain image it can work as an incentive whereas as a negative marker is associated with a certain image the brain would sound an alarm. As a result, somatic markers can influence the decision making process. The far reaching conclusion of Damasio (1994) is that rational decisions are impossible without affect support.

Jeske (2008) concludes that if this hypothesis turns out to be correct then the current thinking in both schools of the decision making (i.e. normative and descriptive) would have to change their approach. In particular, the priority of rational decision making over the role of affects and emotions would become obsolete. Slovic et al (2004, p 314) argue in a similar manner: 'While we may be able to "do the right thing" without analysis (e.g. dodge a falling object), it is unlikely that we can employ analytic thinking rationally without guidance from affect somewhere along the line. Affect is essential to rational action.' Sanfey et al (2006) conclude that neuroscience can help economics to better understand how human beings make decisions, especially since the psychological research has challenged the assumption of rationality when it comes of human behaviour. `

In a more recent research, Campbell-Meiklejohn et al (2008) explored the brain mechanisms of gamblers when they continue playing in order to recover losses (loss-chasing). The authors found out that there is a shifting activity in the brain system depending on at what motivational

state the gambler is. They also concluded that a loss-chasing behaviour may have to do with a failure to balance neural activity when there are conflicting motivational messages. In addition, loss chasing appears to be the default position of gamblers. In a similar research, King-Casas et al (2005) wanted to find out how players behave when investing money with other players. Players could invest up to \$20 with another player. The invested money would triple, but the other player would have to decide how to repay. King-Casas et al (2005) concluded that the behaviour (reciprocity) of players influences future trust in the other player. In this context, Rolls (1994) argues that reputation and trust formation influence neural responses in the brain, namely the dorsal striatum, which is part of the cerebral cortex. Frith and Singer (2010, p 3880) highlight that trust is very often associated with 'emotional activation in the brain' when it comes to economic decisions. In addition, the way individuals are trusted influences neural activity in the striatum. However, it was also observed that when it comes to interaction with others, such as trading partners, there was a risk that individuals were too trusting once the partner had acquired a positive reputation.

During the Lloyd's of London Science of Risk Conference, Campbell-Meiklejohn (2010) emphasised that the insurance industry could benefit from understanding how the human brain works when decisions about risks are being made.

4.2.6 Decision making by managers and their attitude towards risk

It could be argued that the decision making under uncertainty by managers would follow similar patterns as that of other individuals. However, given their power and responsibilities within an organisation their behaviour might differ when it comes to risky decisions.

One of the earlier research in this area is from March and Shapira (1987) who studied the managerial perspectives on risk and risk taking. Based on the surveys carried out, the authors concluded that managers do not necessarily consider risk in the classical way as defined in decision theory. They are less precise in their approach towards risk, but also see risk not as a distribution of probabilities. Risk has normally negative connotations rather than the possibility of a positive outcome which means that they are following the colloquial association with risk.

Whilst decisions in organisation are very often derived in a group, it should be borne in mind that managers sometimes have to make far-reaching decisions, such as the acquisition of a

competitor, where there is an uncertain outcome. Although, significant strategic decisions go through a decision making process within the organisation, such as the board of directors or shareholders, managers will influence – through their power of persuasion - the behaviour of other individuals (Hillson and Murray-Webster, 2005). There appears to be a difference in respect of risk attitude depending on what Kahnemann and Tversky (1979) define as ‘reference point’. There is an assumption that managers should take more risks when the performance of a company is below a certain target, however, when things are not going well then risk should be limited in order not to endanger the current position. In a bad situation managers are more inclined to take more risks in order to have a chance to improve the situation and which would secure their jobs (which is not dissimilar to the loss-chasing of a gambler. What is also interesting is that where a project promises favourable returns (in terms of profits), but also carries a high risk, managers are inclined to adjust their risk perception (so that the risk appears more manageable. They also believe that they are able to control these higher risks, which means that they are able to generate higher than expected profits. They also feel that where they took risks in the past which resulted in positive outcomes, they might believe that they can generate favourable profits again (March and Shapira, 1987)

March and Shapira (1987, p 1411) also point out that ‘individuals do not trust, do not understand, or simply do not much use realistic probability estimates.’ For example, low probability events seem to be ignored which leaves organisations very often unprepared for such an occurrence and managers are surprised about the impact it had. However, this disregard for probability estimates also applies to more frequent potential outcomes. For managers it is more the magnitude of the loss which counts rather than the magnitude multiplied by the probability. Marsh and Shapira (1987, p 1411) argue that this ‘leads to a propensity to accept greater risk (in the sense of variance) [...]’, because they might underestimate the frequency of events for smaller risks which could result in the same overall amount of losses as a high risk event which is estimated to be of low probability.

4.2.7 Group decisions in organisations

The concept of decision making which was discussed in the previous sections focused by and large on individual behaviour. However, it is also important to understand how institutions or groups make decisions and what influences their behaviour. Especially for more complex insurance risk, it is not unusual that underwriting committees, i.e. as a group, make a final decision about accepting a risk or not.

Individuals who are employed by corporations, regardless of whether they are part of normal staff or managers, are subjected to the decisions making dynamics of organisations. The activities of an organisation involve a large number of interested parties which face the organisation not only as individuals, but also as groups or indeed organisations (Kirsch, 1998). These parties will articulate their interests in the context of the organisation which Kirsch (1998) defines as 'context community' and which share a specific form of language or life style. This idea was first muted by Wittgenstein (1953 cited in Kirsch, 1998) who believed that this specific language or life style is being constituted by rules which individuals have to follow in which helps them to communicate and act within the community/organisation.

Kirsch (1998) differentiates between 'original' and 'derivate' language or life styles. Individuals who are part of organisation will initially refer to their private experience or background, but will adapt to the specific context of an organisation. This means that individuals will bring their own interests or objectives or problems into the organisation and will be confronted with the interest and demands of the corporation.

March and Simon (1993) see collective decision making as processes of dealing with conflicts and differentiate four main ways of handling arguments:

- a. *Problem solving*: All parties involved are extremely co-operative and will have constructive discussions and will arrive at a decision through consensus.
- b. *Persuasion*: There is still a co-operative discussion, but the individuals will limit their information sharing, so that is not detrimental to their own position within this process.
- c. *Bargaining*: This way of handling conflicts is characterised by power play and individuals will use all forms of persuasions, such as threats, promises or simple bluff to bring others to change their opinion. A constructive discussion is limited and the efforts of problem solving and achieving a consensus are more or less replaced by bargaining.
- d. *Politics*: This is similar to bargaining, but the actors in this game are not clear about the rules of the game and have to be flexible.

Whilst March and Simon (1993) highlight the behaviour of individuals when there is a group conflict, Hillson and Murray-Webster (2005) emphasise the potential group behaviour when these collective individuals have to make decisions under uncertainty and point out that similar to individuals, groups will also have a collective risk attitude which influences how they deal with decisions. Hillson and Murray-Webster (2005, p 68) also argue that 'while the area of individual

risk attitude has been well characterised and understood, the parallel issues in relation to group risk culture are less well recognised, particularly in relation to business organisation).’ However, whilst it is reasonable to assume that more research has been carried out on individual risk attitude compared to group risk attitude, it is questionable whether individual risk attitudes are fully understood.

Hillson and Murray-Webster (2005, p 69) argue that similar to individuals, groups also use heuristics when making decisions, but they may be exacerbated due to group dynamics. The authors suggest a number of potential heuristics that groups may use and which are shown in Table. However, these factors may not fully fit the definition of heuristics as introduced by Tversky and Kahneman (1974), as these factors are about group dynamics which influence the behaviour of individuals when put under group pressure. As highlighted in section 4.2.2 heuristics are normally used to reduce the complexity of decisions.

Table 10 Group heuristics (Source: Hillson and Murray-Webster, 2005)

<ul style="list-style-type: none"> • Group think – Members of a cohesive group prefer unanimity and suppress dissent; Groupthink refers to the fact that members of a group may avoid confrontation and do not want to voice concerns about a ‘risky’ strategic decisions. Expressing doubts or concerns may be viewed as a betrayal or a sign of not belonging to a group. • The Moses Factor – an influential person’s risk attitude is adopted against the personal preferences of group members; The Moses Factor influences decisions in group when group members follow a charismatic leader and adopt his/her preferred risk attitude which contravenes own convictions. • Cultural conformity - making decisions which match the perceived organisational ethos or cultural norms; • Risky shift – the tendency of a group to be more risk-seeking than its constituent individuals; • Cautious shift – the opposite of risk shift, when the group becomes more risk-averse than its individual members.
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In the context of group decisions, Goto (2007, p 271) argues that there are a number of subjective biases which can influence group decision making. These are listed in Table 11:

Table 11 Source of group bias (Source: Goto, 2007)

Sources of Bias in Group Decision-Making	
Conformity pressure	‘Regardless of objective accuracy, there is an atmosphere that everybody has to agree on an idea that the majority has agreed on.’ This can either mean ignoring one’s own information in favour of that from another group member or accepting faulty information in order not to hurt someone’s feelings.
Excess consideration	Group members might accept a group member’s opinion even if they actually do not agree with it in order not to upset the contributor.
Group polarisation	An individual group may polarise the discussion and convince the group to make a more risky decision.
Minority influence	A minority opinion can become a majority opinion if the group member is able to persuade all other group members.
Social loafing	Goto (2007) also refers to this as ‘free riding’ whereby participants reduce their efforts in group discussions (i.e. minimise their input) if they think there is sufficient discussion within the group.

4.3 Reputation, trust and heuristics

The development of the concept of heuristics has been discussed in section 4.2.2. To reiterate Tversky and Kahnemann (1974, p 1124) regard heuristics as a means to ‘reduce the complex tasks of assessing probabilities and predicting values to simpler judgemental operations’, which is a relatively narrow definition of heuristics. Girgenzer and Gaissmaier (2011, p 454) offer a broader definition of heuristics: ‘A heuristic is a strategy that ignores part of the information, with the goal of making decisions more quickly frugally, and/or accurately than more complex methods.’ Both definitions emphasise the reduction of complexity as a reason for using heuristics. A similar argument can be found at Luhman (2009) who sees trust as a means to reduce the complexity of actions by individuals, so it could be inferred that trust works in a similar way as a heuristic. Reviewing the literature in the area of reputation, trust and heuristics, it appears there is limited research available.

Noteboom (2005) is relatively specific about the role trust may play in the context of heuristics by arguing that individuals act on mental frames which can trigger certain actions, such as

defense, avoidance or negotiations. Frames were first introduced by Goffman (1974 p 21) as follows: 'When an individual in our Western society recognizes a particular event, he tends, whatever else he does, to imply in this response (and in effect employ) one or more frameworks or schemata of interpretation [...]'. Goffman (1974, p 46) further explains that frames answer the question: 'What is going on here.' For Rettie (2004, p 117) frames 'organise experiences; they provide assumptions what is going on. Frames are not mental objects, but concepts used to decipher what is happening around us'.

The concept of framing is also used by Kahneman and Tversky (1979) in the context of Prospect Theory. Tversky and Kahneman (1986, p S257) explain framing in the context of decisions under risk by highlighting that Prospect Theory 'distinguishes two phases in the choice process: a phase of framing and editing, followed by a phase of evaluation [...]'. The first phase consists of a preliminary analysis of the decision problem, which frames the effective acts, contingencies and outcomes. Framing is controlled by the manner in which the choice is presented as well as by norms, habits, and expectancies of the decision maker.'

Noteboom (2005, p 51) argues that 'in the context of trust, I see the representativeness heuristics as providing benchmarks, in the form of prototypes, for efficient, fast identification of trustworthy and untrustworthy behaviour, and guidelines or exemplars for trustworthy behaviour. In organizations, such prototypes for trust are often part of organizational culture. The availability heuristic, in my interpretation, regulates what we actually attend to, by filtering impressions, in emotions that contribute to the selection of frames. 'Continuing on the theme of heuristics Noteboom (2005, p 52) notes that 'anchoring and adjustment indicates that once we select the frame, with corresponding behavioural routines, we do not easily drop it.' Concluding on this Noteboom (2005, p 53) summarises that 'the heuristics appear to complement each other. Representativeness determines how one can interpret behaviour, availability determines which interpretation is triggered, and anchoring stabilises chosen behavioural routines.'

Noteboom (2005) appears to argue that heuristics can be used to establish whether an individual or an organisation is trustworthy. This would certainly extend or even reverse the notion of heuristics established by Tversky and Kahnemann (1974). More convincing is Uzzi (1997) who studied the social structure of interfirm networks and embeddedness which is based on Granovetter (1985) who argues that economic actions are embedded in social relations or networks. Uzzi (1997) conducted a field and ethnographic analysis of 23 clothing (apparel) firms. This industry is highly competitive and Uzzi (1997) assumed that social ties should play a very

limited role. However, the study found that embedded or social ties play a much greater role, even in this industry, than expected. In this context, Uzzi (1997, p 43) found that trust is an overarching feature of these ties and argues that trust operates 'not like calculated risk but like a heuristic – a predilection to assume the best when interpreting another's motive and actions. This heuristic quality is important because it speeds up decision making and conserves cognitive resources, [...].' By quoting one contractor, Uzzi (1997, p43) highlights the reciprocal nature (or I do you a favour if you do me favour) of trust: "With people you trust, you know that if they have a problem with a fabric they're just not going to say, 'I won't pay' or 'take it back'." Furthermore, Uzzi (1997, p 45) suggests that '[...] trust is a governance structure that resides in the social relationship between and among individuals and cognitively is based on heuristics rather than calculative processing.' Kramer (1999, p 582) agrees that trust can have the function of a 'social decision heuristic' which in turn can reduce transaction costs. Marsh (2002) sees a role for heuristics in 'social interactions' (p 49) and 'reciprocal exchange' (p 54) whereby individuals can evaluate whether a partner is trustworthy through the reputation of individuals who one is familiar with. This can, for example, be work colleagues. Furthermore, dealing with a familiar group of people ensures that the risk of a damaged reputation works as a sanction mechanism if trust is broken.

In respect of the question whether reputation can be considered as heuristic, Eberl (2006) argues that reputation (and not trust) could be regarded a decision heuristics relating to the choice of product for purchase decisions as it provides an information surrogate for consumers. This is because reputation is easier available than other more detailed information. Fichtner (2006) also sees reputation as heuristic which facilitate cognitive information and decision processes.

Based on the discussion about the transmission mechanism of reputation and trust, it would be difficult to argue that reputation functions as a heuristic for decision making. However, reputation could be considered as an information surrogate in line with Eberl (2006), as reputational information is more readily available than other more detailed information. Trust, on the other hand, has similar attributes to a heuristic because it reduces the complexity of decisions (Luhman, 2009) by alleviating the uncertainty of outcomes for the individual who trusts another individual or organisation to do what they are expected to do.

4.4 Lloyd's report on underwriting and behavioural science

In a report published in March 2010 titled “Behaviour, bear, bull or lemming?”, Lloyd's of London acknowledges the relevance of behavioural theory for the insurance industry with a particular focus on emerging risks: ‘Underwriters take risks every day of their lives, yet many are unaware of the subconscious thought are clouding their judgements. Behavioural theory tells us there are many unintended filters which distort the way we think about risks. Insurance professionals will benefit being aware of these biases, leading to a clearer thinking and a better management of risks.’ (Lloyd's, 2010, p 2). Lloyd's of London is one of the largest global insurance markets for specialist risks (see section 2.3). This report provides an overview of behavioural theory and attempts to link it to existing underwriting practices. Lloyd's (2010) has not endeavoured to show empirical evidence, instead, the reports aims to heighten awareness of these issues amongst insurance professionals: ‘We believe that insurance professionals will benefit by being aware of the cognitive biases described in this report, leading to a clearer thinking and a better management of risk.’ (Lloyd's, 2010, p 22).

The discussion of behavioural issues focuses on emerging areas of insurance, i.e. new risks such as nanotechnology, where the impact of an event or claims is difficult to assess. One of the shortcomings of this report is that the concepts introduced in the report relating to underwriting decisions are without empirical evidence, so it is not clear whether underwriters do actually behave in the described way. Moreover, the report lacks a consistent link between behavioural concepts discussed and the relevance for insurance underwriting. Notwithstanding this, this is one of the few reports published by insurance market participants, which acknowledges the potential relevance of biases and heuristics in insurance underwriting hence can add to increasing the knowledge in this area. The following paragraphs below summarise the main findings of the report:

The report presents a number of ‘key findings’ from a study of behavioural theories:

1. Perception of risk drives behaviour;
2. Personality affects perception risks;
3. Some groups perceive risk differently to others;
4. Human beings often misjudge risk. The report quotes a number of biases which influence judgement:
 - a. Representation bias
 - b. Availability bias

- c. Anchoring
 - d. Hindsight bias
 - e. Cognitive dissonance
 - f. Confirmation bias;
5. Attitudes to risk depend on how it is presented;
 6. Emotion is a driver of behaviour;
 7. Communication of risk is challenging;
 8. Groups tend to make more extreme decisions than individuals;
 9. When managing risk, the culture within a firm is critical;
 10. Behavioural science is highly relevant to emerging risk management.

One of the biases which is not mentioned in the key findings, but which is later highlighted in the report is 'Optimism' which refers to fact the individuals may perceive their own 'risky' behaviour as non-risky. Reflecting on the insurance industry, the report asserts that in certain market conditions, all market participants have a tendency to believe that 'they are better than average.' (Lloyd's, 2010, p 12)

Another bias where the report makes references to underwriting is confirmation bias where individuals have a tendency to reinforce their own beliefs. This means that individuals utilise only information which confirms their own initial opinion. March and Shapira (1987) came to a similar conclusion when studying the behaviour of managers. Figure 25 illustrates this point. Although the report does not provide an example, there might be a situation where an underwriter would be inclined to accept a risk because of the relationship with a broker or because of growth ambitions. Consequently, he/she might ignore facts which might force him/her to reject a proposal and focus instead on more favourable information which would enable him/her to underwrite the risk.

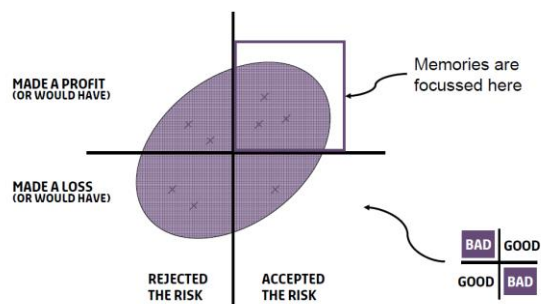


Figure 25 Illustration of risk attitude (Source: Lloyd's, 2010)

An additional bias for which the report provides an example for the insurance industry is cognitive dissonance which occurs when an individual holds beliefs which are inconsistent, for example the wish to live healthily, but continue to smoke. This can also lead to liking what 'you have suffered for (for example after significant efforts we may accept and justify a last minute price reduction to close a deal).' (Lloyd's, 2010 p 12). The report sees cognitive dissonance also as relevant in respect of actuarial models in the context of Solvency II which is the new regulatory framework for insurance companies that is to come into force in 2016 (European Commission, 2014). Amongst others, Solvency II allows the calculation of capital requirements by utilising an internal (i.e. developed by the insurer) actuarial capital model. The report notes that 'there may be a tendency for those that built the models to defend them, given the effort expended to build them.' (Lloyd's, 2010, p 12) Whilst this may be a correct assumption, more relevant is the overreliance on such models by insurers to make underwriting decisions. This is further discussed in section 4.5. On the pricing of risks (policies) which is mostly based on statistical models using historical data, Lloyd's (2010) warns that individuals may have difficulties when estimating probabilities. Table 12 summarises possible biases in underwriting:

Table 12 Possible biases in underwriting (Source: Lloyd's, 2010)

Issue	Description
Prior probabilities are often neglected	For example in one experiment subjects were given a description of a person including that they were shy. Then the subjects were asked if the person was more likely to be a farmer or a librarian. The majority answered "librarian". They neglected the fact that there many more farmers than librarians! The prior probability of being a farmer rather than a librarian (i.e. in the absence of knowing the person is shy) is close to one. The new information does not really change that overwhelming fact. People often focus on such details and miss the bigger picture.
Sample size is often ignored	When asked whether a small or large maternity hospital was most likely to have an above average number of boys many people answer "large hospital" (perhaps because it appears complex and more difficult to envisage?). Yet with a small hospital it is much more likely that an above average number will result; due to randomness of the small sample.
People expect short samples to represent the distribution	One experiment related to coin toss experiments. If H is a head and T a tail, they were asked which of HHTHTI and HHHHHH were most likely. The answer most people gave was the first example; yet they each have the same probability. In short samples, runs of very "biased looking" results can occur. People can assume a trend before they should.
Chain like processes are hard to envision	Many business processes are made up from a long string of connected elements. Each element can fail. The failure of a project can be due to a catastrophic failure of one element - but can also arise from minor failures from a large number of elements. People find it very hard to envision the latter type of failure and hence often overestimate the likelihood of project success.

Issue	Description
People respond to conceivable examples ("scenario bias")	People can often provide a plausible scenario, starting from realistic initial conditions that lead to the desired end state. The ease of producing this scenario is often taken as evidence that success has a high probability. Conversely (and linked to the above point), a failure that can only be imagined from an "unlikely" combination of events is often taken as evidence that failure has a negligible probability. Of course, this can be correct: but ease or otherwise of producing a scenario (very similar to the availability bias discussed above) is not the same as factual evidence.
People can be swayed by redundant inputs	The presence of a large number of data each pointing in the same direction can be seen as a strong indication on the accuracy of predictions. However, sometimes the data is all driven by a similar cause and these redundant data sets do not increase accuracy. Kahneman, Slovic and Tversky call this the "Illusion of Validity".
Halo effects can distort perceptions	It seems that if people like something about an option then they assume it is all good. This can distort estimates of probability (and is discussed more under framing below).

Emotions are also regarded as an important influence in risk perception. Although Lloyd's (2010, p 14) acknowledges that the relationship between emotion and risk perception is 'complex and is currently not well understand', the report argues that in respect of 'decision making under time pressure or when information is limited' risk perception might be more influenced by emotions than by cognitive processes.

In respect of group influences, the report notes that herding can play a significant role. For example, underwriters may accept a reduction in premium rates because everybody else is doing, thus ignoring this may lead to writing unprofitable business.

The Lloyd's report also highlights the importance of trust in the context of underwriting decisions. '[...] trust is easy to destroy and hard to rebuild. [...] For insurers this issue is absolutely critical. Our fundamental product is a promise, we promise to pay in the event of claim. Trust that we have the procedures to safeguard our financial strength is paramount.' (Lloyd's, 2010, p 18) In a concluding section the report provides some guidance in respect of the issues raised in the report, especially relating to emerging risks, which are summarised in the Appendix in Table 27.

As pointed out at the beginning of Section 4.4, the Lloyd's (2010) report can help to provide a better understanding of how risk perception, heuristics and other behavioural influences can impact underwriting decisions. This in turn affects final outcomes and the reputation of underwriters vis-à-vis brokers and other market participants.

All of the issues raised can be relevant at some point or another and it is very unlikely that all of these issues will emerge simultaneously. However, in the context of reputation and trust

framing and emotions are probably the most relevant as they are influenced by the relationships between the broker and the underwriter.

4.5 Lloyd's of London report 'Cognition: Minding Risks'

In 2012, as a follow up to the Lloyd's Emerging Risks report "Behaviour, Bear, Bull or Lemming" (see section 4.4) which provided a broad overview of behavioural decision theory, Lloyd's of London instigated a new report on principles of cognition and risk perception authored by academics from the University of Kent (Weick et al, 2012).

Weick et al (2012) claim that 'risk identification is one of the keys to successful risk management, but we are not equally aware of all risks. Because the brain filters information, people make decisions based on a subset of the available evidence. This fundamental principle of cognition can cause problems in a context such as underwriting where subjective judgements are important. [...] The report draws on various areas within psychology and related disciplines to highlight potential biases in risk perception.' (Weick et al, 2012, p 5). Whilst Lloyd's (2010) only generally discussed existing concepts of behavioural theory which might be relevant in the context of the assessment of emerging risks by insurers, Weick et al (2012) are more specific by focusing on potential biases in risk perception and how they might relate to insurance underwriting. The emphasis on 'cognition' in risk perception infers that only cognitive factors affect risk perception thus ignoring existing research on the potential influence of emotions and their effect on decision making under uncertainty (e.g. Loewenstein et al, 2001; Slovic et al, 2002 covered in section 4.2.3 and 4.2.4).

Similar to Lloyd's (2010), Weick et al (2012) did not base their arguments on empirical research, so it is not clear whether individual underwriters exhibit these behaviours when assessing insurance risks. The report rather draws on existing academic research which the authors consider relevant for insurance underwriting. Notwithstanding this, Weick et al (2012) provide a useful contribution to a better understanding of the challenges insurance underwriters face when making decisions under uncertainty. The following paragraphs provide an overview of the findings of report:

Weick et al (2012) focus on four main areas namely:

- a) Expectations of events

- b) Risk perception
- c) The effects of power
- d) Perspective of risks

a) Expectations of events

Expectation in this report refers to making judgements about potential risks or the occurrence of events. Weick et al (2012) acknowledge that underwriters and brokers should be better placed in identifying risks. However, they recognise that even these experts in risk management will sometimes make errors when assessing the probability and the severity of events. One of the most prominent cases where underwriters misjudged this risk is the so-called 'LMX spiral' which triggered a financial crisis at Lloyd's of London in the 1980s (Schwartzman, 2008). This spiral refers to excess of loss reinsurance which was placed at Lloyd's Syndicates and London Market insurers. Lloyd's of London is a traditional market place for catastrophe re/insurance and during falling rates in a soft market Lloyd's significantly expanded this kind of reinsurance as it was easy to administer and offered attractive commissions to brokers (Schwartzman, 2008). The problem within the Lloyd's market was that there was a system in place whereby one Syndicate would reinsure losses above a certain retention with another Syndicate. However, the latter Syndicate would also reinsure its exposure to another Syndicate and due to limited exposure control this resulted in a *merry go round* whereby basically every Syndicate was reinsuring the other Syndicate. This meant that claims were significantly higher than expected, once Syndicates realised their exposure to certain risks, such as after the Piper Alpha explosion (Thoyts, 2010).

Weick et al (2012) highlight that when it comes to decisions under uncertainty, individuals tend to base their expectations of a loss on personal experience of risks thus underweighting rarely occurring events. Similarly, Hertwig et al (2004) argue that where individuals have to rely on a description rather than own experience, they tend to overestimate the probability of rare events whereas when they make decisions based on experience they tend to underestimate rare events.

In the context of expectations, Weick et al (2012) emphasise three areas which can affect the risk perception of underwriters:

Dependencies: This refers to the misjudgement of correlated risks or dependent risks. This became evident during floods in Thailand in 2011 and which caused significant losses to

re/insurers, partially because insurers underestimated the global interdependencies between manufacturers. For example, some car manufacturers in Europe were unable to continue their production because they were reliant on parts manufactured in Thailand. These interdependencies triggered significant business interruption claims whilst the actual property damage claims in Thailand remained manageable (Lloyd's of London, 2012).

Catastrophe Risk Models: There is an increasing concern that underwriters are relying too heavily on catastrophe risk models to make underwriting decisions without questioning the output. Therefore, underwriters might be surprised if real events trigger higher claims costs than models estimated. Paul Tucker, the Deputy Governor of the Bank of England responsible for Financial Stability, until autumn 2013, highlighted this concern in a speech to the Association of British Insurers (Tucker, 2012) and the CEO of Risk Management Solution (RMS), Hemant Shah, one of the main providers of such risks models, also raised this issue (Reactions, 2012).

Insurance underwriters may also use the output of models as heuristics in order to reduce the complexity of their decision making. Swinney (1999, p 199) observed such a phenomenon when researching the reliance of auditors on computer models to evaluate loan loss reserves for banks and posits that 'since the expert system output is based on the input of experts, auditors may decide the output is 'acceptable' [therefore acceptability heuristics] and over rely on the output.

Social amplification: Weick et al (2012) refer to the fact that behavioural patterns are difficult predict after a disaster. For example, following the 9/11 terrorist attacks, Americans switched from using airplanes to cars because of the fear of further attacks which in turn led to a higher number of road accidents. These abrupt changes in patterns are difficult to predict for re/insurers and motor insurers had to deal with an unexpected higher number of car accidents as a result of higher car usage.

b) Risk Perception:

The way underwriters perceive risks influences how they evaluate risks. Weick et al (2012) concurs with the conclusions of Slovic et al (2000) that activities which are deemed beyond an individual's control are regarded as riskier (such as flying) whereas other activities, such as car driving, are seen as less risky despite the higher accident frequency when using a car. It is not clear why the report concludes that underwriters may overlook less frequent risks in favour of higher frequency risks unless the risk attitude of underwriters is different from the laymen.

An interesting aspect Weick et al (2012) highlight is that insurers tend to focus too much on what they perceive as the most important risks, namely underwriting and investments, whilst ignore operational risks, such as internal controls and governance. Weick et al (2012) refer to a survey conducted by Grant Thornton (2012) amongst chief executive officers and managing directors of London Market insurers which found that there is general tendency to focus their risk management strategy more strongly on underwriting and investment risks whilst downplaying operational risks. However, ignoring operational risks is often a cause of failure of insurers (Grant Thornton, 2012)

An important behaviour dealt with by Weick et al (2012) is that the ambitions of underwriters and managers can influence the risk attitude of individuals who have to make underwriter decisions. This is in line with the findings of Fitzpatrick (2004) who highlighted that underwriting cycles may be driven by growth targets of insurers. Such ambitions or growth targets can also exacerbate a general tendency to overestimate positive outcomes and underestimate negative outcomes. Larrick et al (2009) also argue that challenging performance targets may result in a more risk-seeking behaviour of individuals because they ignore the downside risk. Translated into insurance decisions, underwriters may be more willing to take on riskier business because of this bias.

It is worth noting in the context of risk perception that Fischer et al (2008) point out that significant research has been conducted on how individuals search information when making decisions. However, this research has mainly focused on decision relating to gains and less so on decision relating to the probability of losses. One could argue that gains are just the reverse of losses hence the latter would be implicitly considered by the decision maker. Notwithstanding this Fischer et al (2008) point out that when decision makers, such as insurance underwriters, are confronted with the possibility of losses, the information search might be more thorough, which in turn should allow for a better evaluation of alternatives. Consequently, Fischer et al (2008, p 319) argue that 'in real life contexts, (such as decision making in business or politics) one should be careful not to formulate decision problems exclusively as gain decision [...].' Ditto and Lopez (1992) explored whether individuals are less critical of the information provided if the conclusion is more positive before making a decisions. Ditto and Lopez (1992) concluded that there is evidence that individuals who receive positive information are less likely to be critical of that information (in the sense that they further evaluate outcomes), than individuals who receive negative information. From an insurance perspective, this could infer that underwriters who receive a submission from a broker which shows that the risk has been loss-free for a

number of years might be more willing to underwrite this risk without further analysis. Conversely, underwriters who receive a submission which indicates a number of claims in the past are likely to require additional information from the broker before making a decision whether to underwrite or not.

In the context of the London insurance market, Weick et al (2012) highlight that face-to-face interaction between underwriters and brokers can influence the risk perception of underwriters. Typically, brokers would make presentations to underwriters and would try to present the risk in the best possible light thus potentially influence how underwriters assess the risk presented by the brokers. One could argue that if underwriters find a broker trustworthy they might consider the broker's presentation more positively. As such, trust heuristics might come into play (see also section 4.3)

In a subscription market the reputation of the lead insurers is an important factor for the follow insurers as the latter might be more inclined to sign the slip if they believe they can trust the lead underwriter. However, Weick et al (2012) rightly point out that if there is too much trust than underwriters may ignore warning signals and herding behaviour could result in making the wrong the decisions.

c) The Effects of Power:

Weick (2012) highlight that in the context of underwriting decisions, senior underwriters who have a higher underwriter authority may feel more optimistic about risks because of the feeling of power: 'Power holders feel less vulnerable and are more inclined to take risks, provided that doing so allows them to gain something of value.' (Weick et al, 2012, p 15) As a consequence, these decision makers may end up with worse decisions than individuals with fewer responsibilities. The assertion that individuals with more power are prone to riskier choices was partially challenged by Maner et al (2007) because the riskier choice partially depends on an individual's view of the security of the position within a firm. Where the current position of a manager is stable than individuals tend to be more advantageous hence tend to make riskier choices whereas if there is a challenge to the hierarchy they may act more conservatively. Notwithstanding this, historical failures of insurance companies, for example, Independent Insurance in the UK (Serious Fraud Office, 2008), indicate that inadequate decisions were made by individuals with significant power within a firm. Lovallo and Kahneman (2003, p 3) also argue that there is a tendency by managers to be overoptimistic which the authors put down to

‘cognitive biases – to errors in the way the mind processes information – and to organisational pressures.’

Fischer et al (2011, p 1146) point out that ‘powerful decision makers’ are more susceptible to ignoring ‘information that runs counter to their initial preferences and personal perspectives.’ There is also a tendency to take credit for positive outcomes and blame external forces for negative outcomes. Whist Maler et al (2007) refer mainly to larger projects, such as mergers and acquisitions, these biases are also relevant for underwriting as over-optimism can lead to an inaccurate evaluation of risks. The combination of an overpowering influences and over-optimism can result in wrong underwriting decisions as a junior underwriter may be reluctant to challenge the views of more experienced senior underwriter. This behaviour can also be extrapolated to brokers in the London market as they may be too optimistic about a risk which they wish to place with underwriters. In particular, larger brokers may use their market power to convince an underwriter that the risk they are presenting will be profitable, and the underwriter may succumb to this view despite a diverging initial assessment.

d) Putting Risk into perspective

Weick et al (2012) point to the assertion of Lavallo and Kahneman (2003) that planners tend to focus on their own specific problem or event rather than also considering what problems arose during previous similar external events. In the context of underwriting, Weick et al (2012) argue that underwriters might be inclined to rely too much on the output of risk models without verifying whether such models were able to accurately forecast past catastrophic events. Inadequate models were a concern in the aftermath of Hurricane Katrina where insurers relied too heavily on the output of windstorm models and for the Superstorm Sandy modelling agencies provided a wide range of estimates of losses highlighting the limited predictive power of models (Lockton, 2013).

Weick et al (2012) also point out that more frequent events, such as annually reoccurring floods in the UK, typically receive closer attention and there is a risk that more remote events are not fully captured when assessing the risk of such events, for example, an earthquake in California, or that more long-term developments which could lead to higher losses in the future are ignored. As an example, underwriters who underwrite property risks might be more concerned with immediate exposures, such as floods in an area where they occur on regular basis whilst

ignoring the increasing number of houses built in flood prone areas which will over time increase the insured values in these areas and hence the insured risk.

In the context of decision making under risk and uncertainty, Gilad and Kliger (2008) argue that professionals, who for example work as investment advisors, rely much more on associations from memory when assessing a risky choice than non-professionals. This so called 'priming' affects decision making by stimulating the availability of unconscious information (for example, past experience). As a consequence, professional decision makers may be more intuitive than analytical when evaluating risks. Whilst underwriting in the London market has evolved over years and is now much more reliant on analytical tools, such as catastrophe and pricing models, individual underwriters still have to make a final decision on whether to accept a risk or not which may be influenced by this priming effect. It could be argued that previous positive experience with a broker, whose portfolio has been profitable over a number of years, may affect how underwriters evaluate a risk.

4.6 Conclusions on the Lloyd's reports

The two Lloyd's reports discussed some of the concepts of behavioural decision theory which might be relevant for insurance underwriting, especially where judgement based decisions are necessary. In particular, the report 'Cognition: Minding Risks' highlights that biases, but also the effects of power, can impact how underwriters consider the risks presented by brokers and hence how they make underwriting decisions. Whilst the first report provided only a broad overview of behavioural decision theory, the second report is more specific and contains practical examples how underwriting might be affected by potential biases in risk perception.

However, the lack of follow-up research on the actual behaviour of underwriters makes it difficult to ascertain how relevant the concepts which were discussed in the 'Cognition: Minding Risk' report are pertinent for day-to-day underwriting activities in the London market. Notwithstanding this, the reports are an important contribution to the discussions about the relevance of behavioural theories for insurance decisions.

In summary, understanding how decisions under uncertainty can be influenced by behavioural factors can potentially improve underwriting decisions. Underwriting decisions in the London market are judgement based and are therefore susceptible to errors. As such, the outcome of these decisions impact how market participants in the London market evaluate past actions and hence the reputation of individuals and organisations.

5 Relevance of behavioural decision theories for insurance underwriting

5.1 Introduction

Insurers and their agents, underwriters, make daily decision whether to accept risks which individuals or organisations wish to transfer and what premiums they would need to charge for these risks. These decisions are inherently made under uncertainty (Kunreuther et al, 1995). The uncertainty stems from the fact that an insurer will not know whether or when an event which triggers a payment, such as a fire or a car accident, will happen. The insurers will also not know the amount to be paid for such a claim, although there may be limits to the absolute amount the insurer is liable for. These variables are driven by 'fortuitous' events (Albrecht, 1992); however, insurers are normally able to estimate the overall probability of the number of claims and the total claims payments for a statistically relevant pool of insured risks (Farny, 1995). But even if insurers are able to calculate overall estimates, there are still uncertainties surrounding these estimates, and Farny (1995) identified three main risks where premium calculations may turn out to be incorrect:

- **Deviation from initial estimates:** This means either there is a higher number of claims or higher claims pay-outs than initially expected (or modelled);
- **Changes to the risk profile:** This means that the initially calculated portfolio of insured risks has changed over time. For example, the life expectation of men continues to improve and initial mortality assumption (for example 20 years ago) will by now be incorrect;
- **Error in assumptions:** This risk is different from the first category insofar as these errors occur when the premium calculation is based either on wrong or insufficient information. For example, an insurer may decide to write a new line of business (e.g. accident insurance) where it has to rely on industry wide statistics and which may not reflect the actually underlying portfolio of insureds.

In general, insurers rely on probability models to price risks where probability can be estimated. For unique or more complex risks, underwriters will still calculate premium rates on an individual and hence more subjective basis. As Kunreuther et al (1995) note, the underwriting decision will reflect an underwriter's risk attitude. Despite this, the majority of literature on insurance underwriting decisions still mainly focuses on the mathematical aspect of pricing and (normative) risk theories. However, there is increasing acceptance that these traditional

(normative) risk theories are not necessarily a decisive factor when underwriting unique risk. For example, Ayling (1984) and Keykiah (2000) argue along these lines. Keykiah (2000) points out that where the 'law of large numbers', which means that a large number of similar risks can be pooled (Thoyts 2010,) cannot be applied because of the uniqueness of the risks insured, underwriters might be more influenced by their risk attitude or by the use of heuristics when making underwriting decisions. However, underwriters might not necessarily be aware that these factors influence their decisions.

In this context, Shapira (1993) argues that underwriters are employed by organisations which collectively may have an attitude towards risk which is different from that of the individual underwriter. As a result, these individual underwriters may align their risk attitude to that of the group because of group pressure. For example, a risk averse underwriter may accept risks, which he/she would have normally declined, because he/she feels that the risk offered fits within the group risk appetite. In addition, where underwriters are facing ambiguity, i.e. where there is uncertainty about a loss happening and the size of the claim, underwriters with a higher risk tolerance may see the risk offered more positively (in terms of the loss potential) than it actually is. Consequently, these underwriters may ignore warning signs (such as the claims history of similar risks) and underwrite such ambiguous risks.

Alcock (2008) argues that there is an assumption, in times of sophisticated mathematical models, that underwriter will make rational decisions which is debatable. Indeed: 'Like it or not, us humans are a weird bunch and our decision-making processes are decidedly irrational. Underwriting really is more art than science.' (Alcock, 2008, p 18). Furthermore, Alcock (2008) concludes that one of the reason why human beings make irrational decisions is because of evolutionary forces, which is similar to what Loewenstein et al (2001) argue in the context of risk decisions.

In the following section, an overview of the mathematical approach to underwriting risks will be provided. Following from this, existing research on decision making in insurance will be introduced. As previously mentioned, research in this area is still limited; however, in recent years there has been an increasing number of publications, either academic research or research commissioned by the insurance industry (e.g. Lloyd's of London) with a focus on behavioural or non-mathematical issues of underwriting.

5.2 Mathematical approach to underwriting risks and its shortcomings

As highlighted in the previous section, insurers may use probability models to make decisions about risks and premiums if there is sufficient data available. The main underlying theory for these models is expected utility theory. In principle, this theory states that decisions where the outcome is uncertain should be made by comparing expected utilities of alternatives (Mongin, 1998). When accepting risks insurers will have to estimate the probability that a claim will occur within a certain period and by estimating the size of the claim (Borch, 1974). From there insurers will be able to calculate a premium for each risk which covers the cost of claims (plus expenses and profit margin). For a large and homogenous portfolio, such as motor insurance policies, this is an established process. However, it becomes more complicated when insurers are asked to insure or provide cover for complex and unique risks, such as the unique engineering projects.

One of the instruments available for insurers to minimise their own risk is the use of reinsurance. This means the insurer can transfer some of the risks to a reinsurer for the payment of a reinsurance premium. The utility of such a transaction (decision) is a function of a reduction in the probability of ruin (i.e. when capital held by an insurer is not sufficient to pay out all claims) and the reinsurance premium to be paid which in turn reduces the profit for the insurer. Table 13 illustrates the different choices an insurer has. In this simple example an insurance company can make decisions about its preferred level of risk (expressed as probability of ruin) and the insurer has a choice to transfer a risk to a reinsurer on proportional basis (quota share) starting with zero (no reinsurance) and a maximum of 100 (total transfer of risks to a reinsurer). The utility is a function of the expected profit and the risk that the primary insurer becomes insolvent depending on the level of reinsurance cover and reflects the risk attitude of the insurer. In this example, the utility is maximised at a quote share of 86%. However, Kaas et al (2001, p 3) point out that from mathematical models 'it is impossible to determine which utility functions are used "in practice". Utility theory merely states the existence of a utility function.'

Table 13 Reinsurance decision based on expected utility (Source: Borch, 1974)

<i>K= Quota share</i>	Utility	Expected Profit	Probability of Ruin
0	0.0	0.20	0.3012
0.1	0.056	0.19	0.2982
0.2	0.0101	0.18	0.2725
0.3	0.142	0.17	0.2865

<i>K= Quota share</i>	Utility	Expected Profit	Probability of Ruin
0.4	0.174	0.16	0.2808
0.5	0.195	0.18	0.2725
0.6	0.216	0.14	0.2645
0.7	0.230	0.13	0.2393
0.8	0.237	0.12	0.2019
0.86	0.240	0.115	0.1791
0.9	0.238	0.11	0.1225
1.0	0.231	0.10	0.0

Whilst mathematical models are useful for insurers when underwriting a larger pool of similar risks, they cannot always be applied where underwriters have to make decisions about unique risks. In addition, even where models provide probability estimates, insurers still have to consider the risk of deviation from initial estimates, changes to the risk profile and errors in assumptions (see section 5.1) which require individual decisions. Where underwriters rely on previous claims experience as a basis for setting premium levels, there is a risk that underwriters ignore changes in the risk landscape or have misconceptions about future probabilities (Tversky and Kahneman, 1974). Fischhoff (1998) argues that risk analysis is not value-free as the values of individuals or organisations determine how risks are analysed and interpreted. In that sense, underwriting is not a neutral activity as individuals and organisations will have different attitudes and opinions about the environment. For example, individual underwriters or insurers may be happy to underwrite construction risks in Norway, but might reluctant to accept risks in Qatar regardless of the riskiness of the construction, because of ethical concerns.

Glenn (2003) points out that the insurance industry is too often seen as an objective and rational actor, which is simply a myth. Instead Glenn (2003, p 140) argues ‘that the insurance industry relies on a series of stories that are anything but objective [...]. If there is an objective world out there, we can never truly “know” it. Our interpretations of it will always be limited by our inability to capture it. We will always require narratives to help us determine what variables to employ, and how to interpret the results we find.’ Borch (1974, p 95) cites Shackle (1949) who argues that ‘a businessman will not consider all possible outcomes which may follow a decision he is about to make. Instead he will pay attention to to two *focal values*⁸. These values are the worst and the best outcome which the businessman considers so likely that they must be taken into account.’ Borch (1974, p 95) defends the normative mathematical approach by arguing ‘that

⁸ Italics by author

it would be proposterous to maintain that companies ignore probabilities when they take decisions concerning reinsurance.’ However, Borch (1974) acknowledges that Shackles (1949) describes only what is happening rather what should happen which provides a direct link to descriptive decision theory discussed earlier. In addition, by referring to the reinsurance example in Table 13, Borch (1974) agrees that Shackle’s (1949) claim might apply to insurers because of the focus on only two parameters, namely the expected profit and the probability of ruin.

5.3 Overview of existing research on decision making in insurance

5.3.1 Introduction

In the following sections an overview of existing research relating to behavioural aspects of decision making in insurance will be provided. The studies focus on underwriting practices either at Lloyd’s of London, the Company Market or both. Whilst there is ample general research on decision making under uncertainty available, there is limited research in respect of behavioural aspects of insurance underwriting. The studies which are being discussed are shown in Table 14.

Table 14 Existing studies on underwriting practices

Study	Author (s)	Year	Description	Section
Underwriting decisions under uncertainty	Ayling, D.E;	1984	The study explores the underwriting practices in the London insurance market with a focus on catastrophe reinsurance underwriting	5.3.2
The Shape of Uncertainty: Insurance Underwriting in the Face of Catastrophe Risk	Keykhah, M	2000	The study looked into the decision making process of reinsurance underwriters in the London market with a particular focus on catastrophe reinsurance	5.3.3
From Discreteness to Cooperation- Relational Contracting in the London insurance market	Kyriakou, M;	2002	The study explored the contractual practices in the London insurance market. In particular, the research looked into the behaviour of market participants when it comes to contractual disputes. One of the main themes emerging is the role of trust, reputation and long-term relationships between clients, underwriters and brokers	5.3.4
Trading Risks	Jarzabkowski, P; Smets, M; Spee, P;	2010	This study explored the differences in trading between the London insurance market and the Bermudan insurance market with a focus on reinsurance underwriting	5.3.5
Risk selection in the London political risk insurance market: The	Baublyte, L; Mullins, M; and Garvey, J;	2012	The authors considered the factors which are relevant for political risk underwriters when deciding about accepting or rejecting risks	5.3.6

Study	Author (s)	Year	Description	Section
role of tacit knowledge, trust and heuristics				

5.3.2 Underwriting decisions in the catastrophe reinsurance market

An early research into underwriting practices in the London Market was carried out by Ayling (1984) who looked specifically into the catastrophe reinsurance market. It appears that no interviews were conducted, but rather the slip details of catastrophe risks underwritten were statistically analysed.

The author started his research by quoting Stan Jones of Trimark Underwriting Agencies Limited: “You will never replace a catastrophe underwriter with an equation” indicating the trajectory of research. Specifically, Ayling (1984) argues that for catastrophe reinsurance underwriting, behavioural theories – as opposed to normative economic theories which assume rational decisions - may be more appropriate because of the inherent uncertainty in this line of business. Continuing on theme the author argues:

‘The acid test of the applicability of economic theory to insurance operations is its ability to encompass market decision making. Here the traditional economic theory puts forward the concept of a utility function as the medium by which economic man bases his decisions. [...] The applicability of traditional economic theory to real reinsurance problems seems, therefore, rather limited. [...] Economist might become bewildered at the degree of guesswork and irregularity involved in day-to-day decisions. The behavioural theory in economics frees economic man from the constraints of behaving as a rational pain-and-pleasure calculating machine. Since “pain-and pleasure” in the form of positive and negative cash-flows are difficult to predict for catastrophe reinsurance, the behavioural approach would seem more applicable than traditional economic theory.’ (Ayling, 1984, p 25)

The statement above about guesswork would have to be reconsidered today as the development of risk models has somewhat reduced the use of guesswork, although catastrophe reinsurance remains inherently volatile thus unpredictable. Whilst the use of behavioural theories is being promoted, Ayling (1984) does not specify what particular strands of behavioural theory might be applicable, but it can be assumed that concepts of bounded rationality and heuristics might be relevant as they are briefly discussed later in the research. Notwithstanding this, the research is one of the early attempts to explain *real world*

underwriting decisions rather than regurgitating pure mathematical approaches to underwriting.

Ayling (1984) highlights three main problems when applying risk theory uncritically to (catastrophe) underwriting:

Table 15 Problems with risk theory (Source: Ayling, 1984)

- | |
|---|
| <ol style="list-style-type: none">1. Unrealistic assumptions:<ol style="list-style-type: none">a. Risk theory assumes that the value of business (i.e. the sums insured) do not change over timeb. Probability distributions are always knownc. An inherent presumption that once decisions are made they cannot be reversed2. Divergence from executive attitudes: Risk theory ignores the behavioural aspect of decision making. Managers do not make decisions in a structural or actuarial manner as presumed by risk theory.3. Difficulties with large claims: Larger claims are difficult to predict and the application of stochastic models is difficult. |
|---|

Notwithstanding the difficulties in pricing catastrophe risks in the 1980s because of the absence of risk models, Ayling (1984) argues that excess of loss underwriters are able to rate risks in a 'subjective and expedient manner', despite limited data available. Although, Ayling (1984) does not specify why this is the case, this may have partially to do with the specifics of the London insurance market where underwriters are under pressure to make decisions in front of the broker who presents the risks. Ayling (1984, p 202) also argues that traditional risk theories have their limitations and hence makes a case for combining normative and behavioural theories: 'The idea that price can be fixed by heuristics with no rational justification except that it works, is indeed an uncomfortable thought [...]. The problem of reconciling the concept of heuristics pricing with currently accepted economic theories of price, gapes at present like a hollow cave. The gap will be closed only when theorists are prepared to accept the idea that decision makers under uncertainty are prepared to agree a price simply because they feel it is correct.'

Ayling (1984) also introduces five underwriting points of guidance which he terms 'heuristics' when writing catastrophe risks. However, these points are not heuristics in the sense of

heuristics that ‘reduce the complex task of assessing probabilities and predicting values to simpler judgemental operations.’ (Kahneman and Tversky, 1974, p 1124)

Table 16 Underwriting heuristics (Source: Ayling, 1984)

Catastrophe Excess of Loss Underwriting Heuristics	
<ol style="list-style-type: none"> 1. Write small amounts of a large number of risks to allow the law of large numbers to apply in relation to loss incidence. 2. Try for a certain permanence of risks upon the books. This allows for alterations over time to premiums charged to ceding companies on the basis of new information on loss experience. 3. Include as wide a variety of risks (by class of business and geographically) as possible to lessen the likelihood of a sudden drain on reserves brought about by a single catastrophic event. 4. Charge as much as you can without losing the business 5. Follow the market crowd or lead underwriter in pricing a particular risk or group of risks. 	

The only point where the reduction of complexity in underwriting decisions might come into play is item no 5. Although it is not explained why underwriters should follow the market or lead underwriters, No 5 is a precursor of Thoyts’ (2010) and Keykhah’s (2000) assertion that following underwriters would only accept lead underwriters who have a good reputation in the market whom they can trust to negotiate terms and conditions with the broker.

In a similar vein about underwriting decisions, Phifer (1996, p 119) argues that there is mixture of rationality and subjectivity in the underwriting process involved: ‘Underwriting is neither an art nor a science. [...] Each judgement is unique, but the thinking process and options are limited. There is an interesting mix of gut feeling and exposure analysis in each decision.’ The argument about “gut feelings” points particularly to the influence of affection in the underwriting decision process. In this context, Bellerose (1998, p 74) emphasises that ‘the reinsurer relies on its own personal experience of treaties with similar characteristics and usually charges a flat premium for the whole year [...]’. Ayling (1984) highlighted a number of issues when there is too much focus on mathematical models in respect of (catastrophe) underwriting:

- Underwriting makes unrealistic assumptions about static sums insured over a certain period;
- Underwriters do not necessarily make decisions in a structured manner;
- The ultimate size of a claim triggered by a natural catastrophe is difficult to assess.

Whilst these observations were made a number of years ago, and since then actuarial models for natural catastrophes have significantly advanced, these observations are to some extent still relevant. The first point about sums insured should be more regarded in the sense that underwriters will not always be able to fully evaluate the potential economic consequences (of a natural catastrophe claim). This was highlighted by flood claims in an Australian coal mine in 2011 where a significant increase in coal prices after the inception of the insurance policy had an exponential impact on the amount paid out for the business interruption claim (Yang, 2011). A similar experience could be observed in Thailand in 2011 where flooding disrupted manufacturing around Bangkok resulting in significantly higher business interruption claims than previously anticipated (Birks, 2013)

Ayling (1984, p 199) also calls for a better integration of behavioural and risk theories in order to be provide more value for practitioners: 'Risk theory will continue to play an important role in the development of underwriting systems under uncertainty. [...] however, that, in order to be more of value to practitioners in the market, theorists should replace some of the effort spent on providing more and more insights into concepts of probability with time spent in contemplation of how allowances for human nature could be built into the models.'

5.3.3 Underwriting practices for natural catastrophe risks in the London insurance market

Keykhah (2000) conducted research on the underwriting decision making process of reinsurance underwriters in the London insurance market with a particular focus on catastrophe reinsurance, such as reinsurance cover for windstorms and floods. Keykhah (2000, p 205) sees underwriting in this area very much as 'as a mixture of art and science' and as such it is difficult to formalise the underwriting process.

Keykhah's (2000) empirical research comprised of 42 semi-structured interviews mainly with underwriters ranging from Lloyd's Syndicates, reinsurers and London Market insurers. In addition, interviews were conducted with insurance brokers, Lloyd's Market Risk Unit (now part of the Lloyd's Franchise Board), H.M. Treasury, journalists, market association officials and market information providers.

The research also included several days of observations at Lloyd's of London and visits to a number of head offices of London market insurers in the City of London. Keykhah (2000)

highlights the important role that relationships and reputation play in this market place. This means that underwriters do not simply focus on the adequacy of premium rates and terms and conditions of the policy, but they also have to ‘judge the value of continuity, or continued relations with the client and the broker’ (Keykhah, 2000, p 165) In addition, underwriting is dependent not only on the personal experience, but also on the personality of the underwriter. In this context, underwriting also requires the ‘ability to recognise cues in the market [...]’ (Keykhah, 2000, p 166).

Keykah (2000, p 346) points out that Lloyd’s of London lead underwriters are ‘usually established figures [...] having developed their reputation in particular lines of business.’ Although it is not specified how reputation influences underwriting decisions, Keykah (2000) highlights that ‘the authority and status of the market leaders are revealed less by formal specific scientific expertise or credentials, and more by their reputations, relationships and tacit knowledge of successfully manoeuvring in the risk market. Some of these leading underwriters are no less than gurus in their profession, and their signature on a broker’s slip lends immediate credibility [...]’ (p 237). This quote provides a clue that follow underwriters might use the reputation of lead underwriters as information surrogate in order to inform/influence their underwriting decisions which in turn could reduce the complexity of such decisions.

Keykhah (2000) also highlights the role trust might play to shorten the underwriting decision process: ‘Trust plays such a large role due to the limited time and resources that can be devoted to assessing each and every risk an underwriter is presented. Indeed, trust is employed in some cases as a proxy for assessment’ (Keykhah, 2000, p 239). This resonates with the assertion of Luhman (2009) as discussed in section 4.3 who saw trust as a means to reduce the complexity of decisions.

Keykhah (2000, p 185) also introduces a table of ‘tendencies’ which might be relevant for catastrophe underwriting which the author derived from the findings of prospect theory and other behavioural theories, albeit without a specification of sources.

Table 17 Potential decision tendencies in reinsurance underwriting (Source: Keykhah, 2000)

<i>Tendency</i>	<i>Description of Behaviour</i>
Certainty Effect	Prefer certain outcomes to probable outcomes to, except in the domain of losses
Reflection Effect	Switch risk seeking to risk averse behaviour depending if losses or gains are presented
Isolation Effect	Decisions focus on the incremental gain or loss, not taking into account total wealth

<i>Tendency</i>	<i>Description of Behaviour</i>
Framing	Depending on the presentation of the prospect as a gain or a loss, different behaviour is observed
Anchoring and Adjustment	Initial beliefs anchored on a particular probability, making only minor adjustments thereafter
Gambler's Fallacy	Tendency to attach a memory to independent events
Availability	Tendency to attribute personal perception as objective probability of event occurrence
Sunk Cost Effect	Tendency to keep with loss making decisions since substantial resources have already been committed
Regret	Tendency to make decisions to avoid regret if such options bring big payoffs

In a later chapter of the research study, Keykhah (2000) replaces these tendencies with decision making heuristics and offers a few examples in which situation they might be used:

- **Framing:** Brokers would typically present a risk which they wish to place with an underwriter in the best possible light. Underwriters might be more influenced by the positive message thus ignoring negative signals.
- **Anchoring and Adjustments:** Underwriters might use existing similar risks as a reference point for pricing newly presented risks thus potentially ignoring the peculiarities of the new risk (such as different building structures).
- **Certainty Effect:** The study refers to a phenomenon that underwriters may accept a risk and thus premium income without worrying about future outcomes (i.e. claims) which might be especially relevant in a very competitive market.
- **Availability and Gambler's Fallacy:** The study notes that catastrophe underwriters might be tempted to write more business after a catastrophic event assuming that such an event will not occur again within the next year or so, thus ignoring that the probability of such an event occurring has not changed.

Keykhah (2000) also refers to one of the findings of a research by Kunreuther et al (1995) in respect of underwriting decisions. Kunreuther (1995) found that if a risk was unfamiliar or underwriters could not sufficiently assess it, then the risk would actually be accepted, albeit with a higher premium loading. However, if underwriters were familiar with this risk, i.e. they had dealt with such risks before, but there was incomplete or incredible information, they would

reject insurance coverage. Keykhah (2000, p 211) concluded that this presented a 'curious paradox' which may; however, have to do with a specific attitude towards uncertainty: 'Hedging against what one does not know might have been considered easier than accepting a risk for which one knows particular important information is missing.' Keykhah (2000) suggests that in light of the above mentioned results, underwriters might be less analytical than expected, and proposes to look at other explanations for underwriting decisions than just expected utility or profit maximisation, but does not propose specific areas of research in respect of the role of relationships and reputation in the London Market,

Keykhah (2000) makes an important point by highlighting that a lead underwriter's past performance or reputation will influence whether other underwriters are to follow the terms and conditions negotiated by the lead underwriter. In a concluding assessment about academic research on insurance underwriting, Keykhah (2000) notes that most studies have ignored the importance of the role relationships play between the various market participants (i.e. insurers, brokers and clients).

5.3.4 Relational Contracting in the London Marine Insurance Market

Kyriakou (2002) looked into the contractual practices in the London marine insurance market and in particular how insurance contracts are formed, and how market participants behave when it comes to the enforcement of legal rights under insurance contract law. The findings of the research are based on 20 interviews with 9 Lloyd's Syndicates, 6 Company insurers, 1 P&I Club and 4 claims administrators working either for a Lloyd's Syndicate, a Company insurer or a P&I Club. In addition, a 3-day ethnographic study was undertaken to observe how 33 insurance contracts were concluded in the London marine insurance market.

Whilst this research was primarily focused on the legal aspects of the London Marine Insurance Market, other themes emerged from Kyriakou's (2002) study. In particular, the notion of trust and the role of long-term relationships in the London marine insurance market are important factors and Kyriakou (2002, p 176) argues these long-term relationships 'reduce transaction costs, but also enhance trust and confidence toward the other party [...].' In concluding on the objective of this study, Kyriakou (2002, p 305) posits that 'the London market has established practices [...] which respect flexibility, enhance face-to-face negotiations and support

alternatives to litigation.’ Especially the latter factor is driven by the desire to maintain trust and long-term relationships. However, as discussed in section 2.11 and 2.12, there is unease about the current insurance contract law for commercial insurance (section 2.11) and there has also been an increase in claims disputes in recent years (section 2.12). Insofar, Kyriakou’s (2002) findings are more optimistic and somewhat contradict the concerns raised by the Law Commission (2012) and Mactavish (2011) in respect of the disclosure of material facts by policyholders and increasing attempts by insurers to avoid paying claims on grounds of non-disclosure of material facts.

The study of Kyriakou (2002) also highlights the role of reputation is playing in the London market. What is maybe surprising is that despite the emphasis on trust and reputation, Kyriakou (2002) did not discuss existing academic research on these topics; neither is there a discussion about how trust and reputation might interact. Notwithstanding this, Kyriakou’s study provides important insight into the fabrics of a specific, but crucial segment (see section 2.3) of the London insurance market. Kyriakou highlights that the main criteria for marine underwriters in terms of doing business are: ‘profitability, quality of the client and the broker, market ethics, personal experience and intuition. And the underpinning message is trust’ (Kyriakou, 2002, p 209).

Kyriakou (2002) also highlights the reputation of the client as a decisive factor by quoting an interviewee:

“If somebody has very poor results or bad reputation, you do not want get involved or you apply very strict conditions on them [...]” (Kyriakou, 2002, p 210)

The role of the broker in this market segment is also acknowledged by underwriters:

“The broker is crucial. [...]. If you are a broker and I write a big account to you, and I know you are honest and straight-forward, and you try to do a lot of business, then I would be much more inclined to write business to you rather than to a broker with whom I have no relationship.[...]”(Kyriakou, 2002 p 211).

Kyriakou’s study also points out that insurers may be more lenient when it comes to the late payment of premiums by clients if there is high-level of trust by quoting an underwriter: *“Yes, we tolerate late payment, if there is mutual trust and willingness to work [...] A factor would be mainly the length of relationship. Obviously, a longer relationship, generally speaking means a better relationship. Therefore there is more flexibility.”* (Kyriakou, 2002 p 240).

What this statement infers is that long-term relationships built a positive reputation thus creating trust for the underwriter to allow this flexibility. Conversely, where clients have a bad reputation then there would be mistrust hence underwriters would apply less flexibility.

Kyriakou's study provides a revealing underwriter's statement about the relation between underwriting and claims paying behaviour. In particular, the presumption that undercutting premiums in the London Marine market is likely to lead to a reputation for not paying claims:

"If you are known as somebody who does not like paying claims, it is far more likely that you are known as a cheap underwriter, because you cannot pay claims since you do not have enough premium. So, you have a bad reputation. If you are known as an expensive underwriter, you are probably known as being far more lenient and prepared to compromise claims, because you have enough premiums." (Kyriakou, 2002, p 279)

In terms of how to deal with a disputed claim, the study emphasises the role of the broker in the negotiation process by quoting an underwriter: *"There are probably two or three brokers I do not like doing business with, because I do not actually trust what they tell me [...] It is only a very small percentage, not very many people; but there are still people that I'd rather not do business with."* (Kyriakou, 2002, p 252).

Presumably this statement can be applied to the whole value chain in the London insurance market, not just to the willingness to pay a claim without disputing it (ex-gratia payment). Kyriakou (2002) highlights that marine underwriters are conscious of the importance of claims handling, and how this can affect their reputation vis-à-vis brokers, by quoting a number of underwriters:

- a) *"I prefer to have a reputation that if we take your money, we pay your valid claims [...]. Ultimately, there is the commercial issue. Brokers know who the difficult underwriters are and avoid them."* (p 254)
- b) *"I know underwriters who have a bad reputation of paying claims [...] and brokers think twice before going to them."* (p 255)
- c) *"It is going to be detrimental to your position the fact that you cannot pay valid claims [...]. Some companies have the reputation for not paying claims and have lost a lot of business because of that. Everybody in the market knows who they are."* (p 255)

- d) *“It gets bad publicity if everyone thought that you run to lawyers every time you have a case [...]. If enough brokers thought that all you do is to decline to pay any claims, you would not get any business.”* (p 280)

Kyriakou (2002, p 259) concludes that trust is the ‘underpinning element’ when it comes to the reputation for paying claims. In addition, the author argues that long-term relationships between clients, brokers and underwriters are evidence of trust having built up over years. As a consequence, underwriters may be more willing to avoid legal disputes and find non-legal solutions to conflicts if there is a long-term relationship which is based on trust. This can apply to areas, such non-disclosure of material facts or the validity of a claim.

Kyriakou (2002, p 260) also highlights the connection between trust and reputation by citing another underwriter:

“An underwriter besides his assets has something very precious, his reputation [...]. If we have doubts about somebody, we just do not deal with them. Of course, sometimes, we make a bad judgement but it is very rare and, if there is a problem, we try not to clash because we want to protect our reputation; we try to find a reason for an arrangement.”

The focus of the research of Kyriakou (2002) was on contractual relations in the London marine insurance market. This may explain why, despite the common theme throughout the study that reputation and trust are important factors in these contractual relations, there is no further exploration of mechanisms and functions of trust and reputation in the London insurance market.

5.3.5 Trading Risks – the Difference between Bermuda and Lloyd’s of London

Jarzabkowski et al (2010) looked into the different working practices through a year-long ethnographic study of the London and Bermuda reinsurance markets with 17 insurers and brokers (including Amlin plc, Hiscox plc and AON Benfield) participating in this study. The ethnographic study involved audio and video recordings of over 800 transactions in London and Bermuda during 2009/2010 reinsurance negotiations. Although the published report is only a summary of the year-long research, it provides relevant insights into the workings of the London insurance markets and how they differ from the Bermudian insurance market.

Whilst the research was focusing on reinsurance, some of the findings are also relevant for the entire London insurance market. One of the main differences between Lloyd's of London and Bermuda is the prevalence of face-to-face interactions at Lloyd's of London despite the advances in technology and electronic communication. Jarzabkowski et al (2010, p 3) conclude that 'Face-to-face interaction is a valuable resource in generating the trust that supports long-term relationships and repeat transactions over many years. It also aids complex negotiations by increasing consensus between parties [...].' However, there is also a warning that face-to-face interaction can result in brokers and underwriters feeling obliged to do favours to each other. Notwithstanding this, Jarzabkowski et al (2010, p 4) highlight the way business is done at Lloyd's makes it easier to structure complex programmes: 'Face-to-face negotiations, supported by deep relationships with and trust in the broker, supplement lack of hard, quantifiable information and enable complex programme structures to be tailored to create value [...].'

Jarzabkowski et al (2010, p 4) also point out that 'the closely knit face-to-face market generates strong norms that exercise social control and behaviour.' This appears to be similar to the sanction mechanism of reputation and trust discussed in section 3.9. In terms of the broker/underwriter relationship in the London market, Jarzabkowski et al (2010, p 4) highlight that 'business relationships are formed through frequent interactions that include social events, such as dinner, drinks, golfing weekends and race meetings. These relationships advantage the broker of the face-broking that occurs in every stage of the trading process. When firm order terms are lower than expected, or when a larger line or strong lead is required, brokers can stimulate a sense of obligation, either by intimating current or future favours, or more subtly, by calling on strong social ties. Simply, it is hard to say no to a person's face, particularly when the relationship is also social.'

This is obviously a generalised observation across the whole London insurance market and ignores that not all underwriters and brokers will have strong social ties, but still have to do business together. Jarzabkowski et al (2010), however, argue that such traditional social relationships are being replaced by more business-like relationship where good underwriting practices become more relevant. The authors conclude that 'personal goodwill trust ("he's a nice guy; we've played golf together") is being superseded by trust in the information cedants provide or the practices they employ ("they're good underwriters"). Good relationships produce information and trust that helps partners to transact business in the face of uncertainty.' (p 11)

5.3.6 Risk selection in the London political risk insurance market

Baublyte et al (2012) conducted research into the way political risk insurance is being underwritten in the London insurance market. The research methodology comprised a total of 14 semi-structured and unstructured interviews with underwriters and brokers in the political risk market. These interviews were supplemented by documentation reviews, observations and informal discussions.

Political risk insurance provides cover for losses stemming from government intervention into commercial transactions. There are six main covers available:

- Consequential financial loss: This provides cover for financial losses due to political actions;
- Political violence: Provides cover for physical damage to property as a result of political violence;
- Confiscation of property: Provides cover for losses due to the confiscation of property as a result of political actions;
- Inconvertibility of currency: Covers financial losses if a currency cannot be converted or funds cannot be repatriated outside the country;
- Trading risks: Covers financial losses if pre-paid goods are not delivered or if there are import/export embargoes;
- Kidnap and ransom: Provides cover against kidnap, hijack and injury, including ransom money to be paid to release individuals. (Lloyd's of London, 2013)

Surprisingly, given the complex nature of this class of business, Baublyte et al (2012) did not provide an explanation of what exactly is being underwritten.

Notwithstanding this, through interviews with underwriters and brokers involved in the class of business, Baublyte et al (2012) identify a number of initially four broad categories of risk selection criteria relevant for political risks underwriting; some of which may be relevant for other classes of business written in the London market:

- Country
- Client
- Tacit Knowledge
- Heuristics

However, as the research progressed these categories were further expanded to include:

- Intuition
- Trust
- Reputation.

Country: From the heading ‘political risk’ this category is self-explanatory. The more unstable the political situation in one country is, such as Nigeria, the higher the risk for the underwriter.

Client: Here hard facts, such as financial strength of the client, but also soft facts, such as the clients experience in trading in certain countries, play a role. Especially in the area of political risk, an asymmetry of information, which gives rise to moral hazard and adverse selection, is potentially of greater risk than in other lines of business.

Tacit Knowledge: The authors included this category in consider tacit knowledge as the opposite to explicit knowledge which can be explained and articulated. Baublyte et al (2012) argue that humans gains knowledge which they cannot always fully explain. Tacitness can therefore be defined as something that ‘can be imperfectly articulated through the use of metaphors and storytelling; [...] (Baublyte et al, 2012, p 1108). However, this category was later abandoned and reorganised under other (additional) categories, such intuition, trust and reputation without providing a full explanation. It could therefore be argued that tacit knowledge is not a useful category in this context.

Intuition: Because some aspects of political risk underwriting are unique, underwriters will have to rely on a more subjective view of the risk they are being asked to underwrite, which is partially related to limited historical claims data. Some of the interviewees described this process as using ‘instinct, sixth sense or gut-feeling’ (Baublyte et al, 2012, p 1108). There is also a quote from one political risk broker on his/her view of the underwriting process which provides a good summary as to how underwriters assess risks in the London market:

“Generally, who is the potential client, potential insured [...] Underwriters may also pay some passing attention to the broker because if they don’t know the insured but they know the broker has a good reputation – so probably he made the right checks. And then there is bigger picture what is the country, what is the risk itself. Often an underwriter will not want to deal with some companies because maybe they had bad experience with them in the past. But the actual process will vary from syndicate and company. Some people have very structured processes and some

tend to do it in a more It is more of a judgemental way They have gut feeling or instinct.”(Baublyte et, 2012, p 1108).

Trust: For Baublyte et al (2012, p 1108) ‘trust plays a vital role’ in the underwriting process for political risks and conclude that underwriters may not only assess the risk which is being presented by the broker, but also the individual broker himself. ‘From the underwriter’s point of view, a risk can be perceived as more acceptable if presented to an underwriter by a broker with whom he or she has a successful underwriter-broker relation that is built on trust which is a function of underwriter’s expectation of broker’s goodwill and competence.’ Expanding on this: ‘Political risk underwriters, generally, feel more comfortable accepting a risk if they can trust a broker; where trust is earned through shared experiences in both the profession and the social realms. Moreover, underwriters try to develop and maintain long-term relationships with their favoured brokers with an aspiration to earn their loyalty, i.e. “shadow-of-the-future” effect.’ (Baublyte et al, 2012, p 1109) The trust in this sense is seen as expectation of future behaviour.

Heuristics and memorability: There is an argument that if there is uncertainty in respect of a risk (proposal) which is being presented by the broker, ‘underwriters tend to employ memorability, imaginability and similarity as cues for subjective probability.’ Baublyte et al (2012, p 1110) For example, underwriters may judge the risk by the ease at which similar risks or claims events can be recalled.

Reputation: In respect of this category Baublyte et al (2012, p 1111) conclude that ‘reputation is intimately related to heuristics’. However, the authors only relate this category to the potential insured and not to other participants in the market which is somewhat inconsistent. Reputation is seen as perception of the riskiness of the client which is based on a historical track record, so a client who has been trading in a particular country for a while will have gained a reputation for being successful in that specific country thus reducing the risk of default. As a result, this reputation facilitates the decision process of the underwriter; hence reputation is related to heuristics.

The relationship between underwriters and brokers is seen in the context of trust. This may explain why there is a separation of the category of reputation relating to clients, and trust relating to underwriters and brokers. However, whilst the research of Baublyte et al (2012) provide some insight into the mechanics of political risk underwriting in the London market, they

do not appear to consider whether or how the discussed categories interact, or why reputation and trust are seen as totally different concepts.

5.4 Conclusion

This chapter examined a number of research studies which all dealt with how the London insurance market functions, either more generally or in specific market segments, such as catastrophe reinsurance. The main findings can be summarised as follows:

- Ayling (1984) looked into the catastrophe reinsurance underwriting practices in catastrophe in the London Market. Ayling (1984) argues that underwriters are not the rational decision makers as normative economic theory presumes because underwriting decisions consist of 'guesswork and irregularity' (p 25). Consequently, Ayling (1984, p 199) calls for a better integration of behaviour theories and (normative) risk theories in particular how 'allowances for human nature could be built into the models.' The research provides an insight into the underwriting practices of the London market as despite the early publication of the research, underwriters still have to make judgement based decisions and cannot solely rely on statistical models. Although Ayling (1984) calls for a better integration of behavioural decision theories, there is no consideration as to how reinsurance underwriting might fit into these theories. In addition, the role of trust and/or reputation was not discussed at all, despite the importance of these two concepts for underwriting emphasised later by a number of authors (see Keykhah, 2000 or Baublyte et al, 2012).
- Keykhah (2000) conducted research in the same insurance segment as Ayling (1984). Keykhah (2000, p 205) concludes that it is difficult to formalise the underwriting process because it is very much 'mixture of art and science' which echoes the assertion of Ayling (1984) of guesswork and irregularity. Keykhah (2000) also suggests a number of 'heuristics' which underwriters might employ to facilitate underwriting decisions. For example, Keykhah (2000) describes 'framing' as one of the heuristics which might be used whereby underwriters might be positively influenced by the optimistic risk presentation of brokers. Brokers make daily presentations to underwriters and this heuristic might be particularly relevant when considered in the context of trust and reputation. For Keykhah (2000) these two concepts play an important role in the London

insurance market. However, despite the importance of reputation and trust, the literature review focuses solely on the concept of risk and decision making.

- Kyriakou (2002) does not focus on underwriting or broking, but on what happens after the inception of insurance contract in the London Marine insurance market. This refers in particular to claims handling and the interpretation of terms and conditions when a claim is notified to the underwriter. Similar to Keykhah (2000), Kyriakou (2002) emphasises the importance of trust and reputation, albeit in a different market segment. The research acknowledges that the way underwriters handle claims will influence their reputation vis-à-vis brokers and in turn influences the ability to get business from brokers. The built up of trust between underwriters and brokers through long-term relationship is also emphasised. However, it is not clear why a long-term relationship in itself should create trust. In addition, no broker was interviewed during the research which makes it difficult to verify statements of underwriters regarding impact of a bad reputation for claims handling on, for example, attracting new business. Despite the emphasis of the role of trust, reputation and long-term relationships, Kyriakou (2002) offers no theoretical discussion of these concepts, especially how they might interact and their transmission functions.
- Jarzabkowski et al (2010) conducted an ethnographic study into the differences in respect of the business placing processes between the London insurance market and the Bermudan insurance market. However, the published report is only a summary of the one-year study, so lacks the details of the above mentioned academic research. Notwithstanding this, the study emphasises that there are significant differences between the London and the Bermudian reinsurance market, of which some are because of the distance between underwriter and brokers and some are because of different (and possible inefficient) business practices. More importantly, similar to Keykhah (2000) and Kyriakou (2002), Jarzabkowski (2010) argues that the face-to-face nature of the London market enables mutual trust between underwriters and brokers and aids complex negotiations. However, the study also points out that relationships are sometimes built up by social favours. For example, brokers would invite underwriters to social events, such as Cricket, and likewise underwriters would invite brokers to events which they may sponsor. These invitations or favours may then increase the pressure on the underwriter or broker to do more business with each other. The role of reputation is not mentioned in the report at all. Whilst the study report is only summary

it is still a noteworthy contribution to an understanding of the London market especially when compared to the Bermudan reinsurance market.

- Baublyte et al (2012) is the most recent research into underwriting practices in the London market with a particular focus on political risk underwriting. Baublyte (2012) highlight that because of the nature of political risk underwriting, where historical claims data may not be available, underwriters will have to form a subjective view of the risk or 'gut-feeling' (p 1108). Baublyte (2012) also make a point about the role of trust, reputation and long-term relationships in this specific segment which can be generalised for the entire London market. Underwriters may also be less concerned about the client's moral hazard if the broker has a good reputation for presenting a fair view of the risk. Underwriters also feel more comfortable accepting a risk if they can trust a broker that they are honest when it comes to describing the risk. This is similar to the trust function in the previous sentence, so it is not clear how trust and reputation interrelate in this process. Baublyte (2012) also posit that reputation is intimately related to heuristics, although there is no clear explanation how reputation might function as heuristics. Similar to Kyriakou (2002), Baublyte (2012) emphasise the role of trust and reputation in the political risk underwriting process, without further explaining the transmission function and how they relate to each other.

Based on the findings of the empirical studies the insurance decision process diagram as presented in chapter 2 has been expanded to take account the findings in respect of reputation and trust from the research.

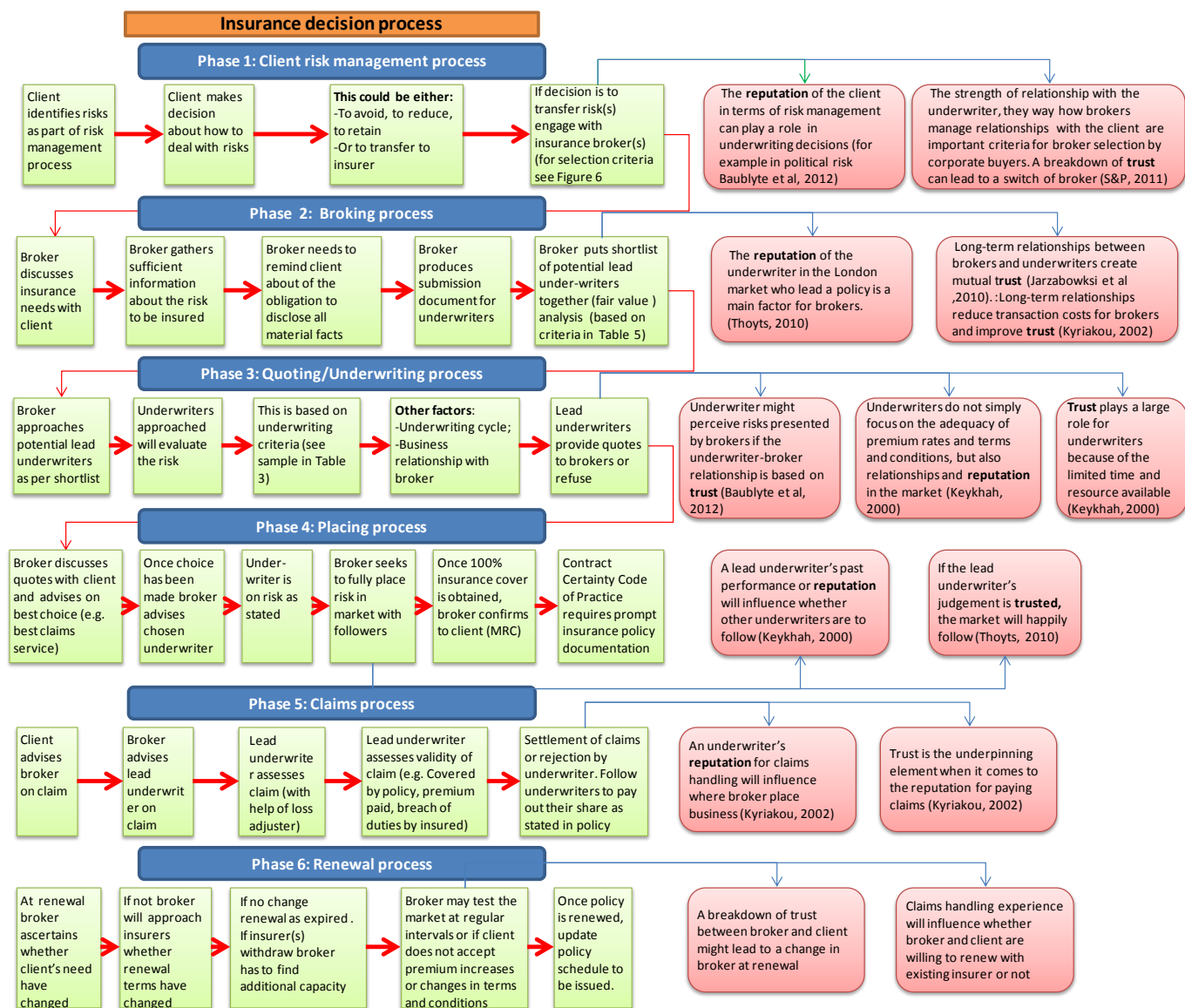


Figure 26 Insurance decision process and the role of trust and reputation (own diagram)

With the exception of Ayling (1984), all the aforementioned studies emphasise the importance of trust. However, in Jarzabkowski et al (2010) research reputation plays no role, whereas Keykhah (2000), Kyriakou (2002) and Baublyte et al (2012) see an important role for both reputation and trust in the London insurance market. Notwithstanding the variations in focus, all studies discussed have contributed to making progress towards the research objective of understanding the placing process in the London market albeit to varying degrees. Keykhah (2000), Kyriakou (2002) and Baublyte et al (2012) have provided an insight into how reputation and trust might influence decisions in the London market. However, as previously highlighted, the functions of reputation and trust, and the transmission mechanism, have not been (fully) explored.

6 Research Design and Methodology

6.1 Introduction

This chapter sets out the research design and methodology employed for this study. Whilst the first part of the chapter deals with the aims and objectives of this research, the middle section discusses the research methodology adopted for this study. Finally, research procedures are considered in the last section.

This thesis acknowledges that there is a considerable volume of literature available on research methodology, as well as methods, and each publication has its own individual structure. In addition, as Greener (2008) points out some of the terms, such as research methodology and methods, are used interchangeably by some authors. This thesis adopts the structural approach suggested by Saunders et al (1997) who promote the use of the 'research onion' for a discussion about scientific research in business.

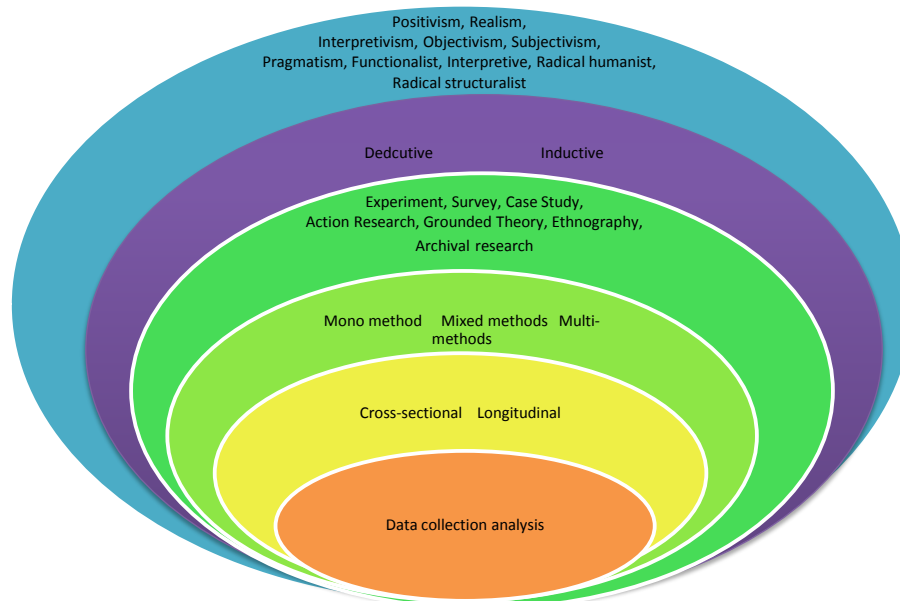


Figure 27 Research onion (based on Saunders et al 2007)

6.2 Aims and objectives

The main aim of this thesis is to explore how reputation and trust influences the insurance decision making process, with a particular focus on insurance underwriting and broking in the

London insurance market. In addition, the study aims to explore whether some of the findings of academic research on the use of heuristics (e.g. Tversky and Kahnemann, 1974) in relation to decision making under uncertainty can be applied to the insurance sector. For example, Eberl (2006) suggest that reputation might be used as a heuristic in order to reduce the complexity of decision making whereas Noteboom (2005) sees trust as a heuristic. This thesis seeks to reduce the knowledge gap in this area. In the following chapters an appropriate research methodology will be discussed. In particular, why a phenomenological paradigm is regarded as the most suitable research philosophy will be considered.

6.3 Research Questions

Insurance is by nature an intangible product as the main product feature, paying claims or paying an agreed sum at expiry, can normally only be tested at a later stage. Policyholders are therefore faced with uncertainty as to whether insurers are able and willing to honour their commitments. Fichtner (2006) points out that there is an inherent uncertainty in market transactions and market participants need instruments to better deal with this uncertainty. Fichtner (2006) then suggests that reputation and trust could be such instruments.

Insurers have to make daily risk taking decision under uncertainty. This is particularly evident for re(insurers) who write larger and more complex risks, such as construction projects or power plants. Although there is an expectation that decisions by re(insurers) are made on a rational basis, this has been put into question. Early research by Tversky and Kahnemann (1974) argued that individuals use a limited number of heuristics to reduce the complexity of decisions under uncertainty.

One of the motivations for this study was to explore the extent of the role for reputation and trust in the London Market, and how these two concepts interact in the daily decision making process between insurance underwriters on one side and insurance broker (and indirectly insurance buyers) on the other side. Consequently, a clearer picture should emerge from this study. In order to achieve this objective the following sub-objectives are considered (as listed earlier in chapter 1):

1. To provide a comprehensive literature review on generic concepts of reputation and trust;
2. To investigate the concepts of corporate image and corporate identity and how they differ from reputation;

3. To explore what general role reputation and trust might play in business decision processes;
4. To examine what specific role reputation and trust might play in the insurance sector;
5. To investigate what existing concepts of behavioural decision theory might be relevant for the insurance underwriting process;
6. To explore how reputation and trust influence decisions by underwriters, brokers and insurance buyers;
7. To investigate whether there is evidence that reputation and/or trust could be utilised to reduce the complexity of underwriting and broking decisions.

6.4 Research philosophy

Research philosophy is concerned with how knowledge is being developed and the nature of this knowledge. The research philosophy adopted by the research will influence the research strategy and methods applied (Saunders et al, 2007). By understanding the different philosophies researchers will be in a better position to argue for different research approaches (Dobson, 2002).

Saunders et al (2007) argue that a researcher who is looking for factual information is likely to have a different view on how research should be conducted than a researcher looking into behavioural or attitudinal issues. There are three main strands of research philosophy which are discussed below:

Epistemology:

For Saunders et al (2007) epistemology is concerned with what constitutes acceptable knowledge in research whereas Burrell and Morgan (1979, p 1) highlight that it is about how knowledge is being gained and 'how one might begin to understand the world and communicate this as knowledge to fellow human beings.' For Erikson and Kovalainen (2008, p 14) epistemology deals with the question as to 'what is knowledge and what are the sources and limits of knowledge', and it also about how knowledge can be produced and argued for. For Greener (2008, p 34) epistemology should answer three fundamental questions:

- 'To what extent can we know something is true?

- Does a phenomenon (e.g. gender discrimination at work) have an objective existence, or is it only existing in the minds of those who discuss it?
- Can we investigate it directly, or must we interpret its meaning from what people say about it?

Saunders et al (2007) consider three main epistemological strands, namely positivism, interpretivism and realism. Whereas positivism is more linked to natural science and involves mainly empirical testing, interpretivism looks at existing phenomena and tries to explain it (Greener, 2008). Realism, on the other hand, accepts that there is 'a reality quite independent of the human mind' (Saunders et al, 2007, p 104). Realists attempt to uncover the mechanism and structures which drive observed activities (Dobson, 2002). Bhaskar (2011, p 10) sees a realist position as a 'theory about the nature of the being.' Blaikie (1993) argues that realism looks into phenomena, but accepts that reality could exist regardless of what is being observed or being researched.

As pointed out above, *positivistic research* is very much linked to natural science and researchers are typically working with an 'observable social reality and that the end product of such research can be law-like generalisations [...].' (Remenyi et al, 1998, p 32) In addition, the researcher is seen as an 'objective analyst and interpreter of tangible social reality.' (Remenyi et al, 1998, p 33) Adopting a positivistic research strategy also means that hypotheses are likely to be developed based on existing theory. These hypotheses provide the basis for gathering information or facts which can be utilised for subsequent hypothesis testing (Saunders et al, 2007). According to Gill and Johnson (2002), positivist research is likely to seek a very structured research methodology, so that it can be easily replicated. Saunders et al (2007) argue that due to the focus on quantifiable observations there is more emphasis on statistical analysis.

Interpretivism, on the other hand, tries to explain the differences between human beings as social objects and there is an argument that this approach is more appropriate for business or management related research (Saunders et al, 2007). By nature, business processes can be complex and are often unique which would make it difficult to draw general conclusions from the research findings which a positivist approach aims to achieve. Whilst for the purpose of this thesis empirical data could be collected, it would not necessarily reflect reality. It can also be argued that reputation and decision making processes are intangible phenomena which cannot be as easily observed as a manufacturing process. Business processes are by nature fluid and as such an interpretivist approach might be more appropriate as it not necessarily about testing hypothesis, but explaining phenomena.

Realism is split into two strands: *direct and critical realism*. Direct realism argues what you see is what you get, i.e. that one's individual perception reflects reality. Critical realism on the other hand accepts that one's own perception might be different from reality. Saunders et al (2007) argue that as business research is within the environment in which business activities are being conducted, critical realist epistemology might be the most appropriate strand. Bhaksar (2011) points out that phenomena which are being researched are only part of a wider social structure which needs to be understood.

Ontological considerations:

Ontology concerns the nature of reality and the very essence of the issue being researched. As such, social scientists will have to clarify whether the subject matter which is being investigated is the result of external pressure on individuals in an organisation or whether it is the product of an individual's self-determined behaviour (Burrell and Morgan, 1979). Based on the definition of reputation in Chapter 3 reputation concerns, inter alia, the evaluation of previous actions which can involve a degree of subjectivity. Likewise decision making is influenced by previous experience of people and partially depends on the risk aversion or risk appetite of the person who has to make an (underwriting) decision (Kunreuther, 1995). Hence this process is heavily influenced by the subjects involved and not just by guidelines issued by management or the firm who buys insurance. As a result, these individuals cannot just be regarded as empirical subjects (Burrell and Morgan, 1979).

Axiology:

Axiology is concerned with judgements made as part of the research. Saunders et al (2007) argue that the choice of research topic is in itself already a value statement and further statements will be required throughout the research. An interpretivistic approach lends itself to a more value based research given the subjective nature of the study. A positivistic approach would be considered as less biased as research results can be interpreted through objective data (e.g. through experiments) and not through a subjective judgement of, for example, the content of interviews. As this study is concerned with behaviour and the attitude of the people involved in the placing process, a phenomenological approach is more appropriate. Reputation and trust are by nature very subjective and both the researcher and those participating in the research (e.g. underwriters, insurance brokers and corporate buyers) will have differing views on the

nature of reputation and trust and how these two concepts interact in the insurance decision process. Hence there cannot be a value-free research on this topic.

Research paradigm

According to Kuhn (1996, p 175) research paradigm 'stands for the entire constellation of beliefs, values, techniques, and so on [...].' Burrell and Morgan (1979, p 23) see paradigms as a 'frame of reference, mode of theorising and *modus operandi* of the social theorists who operate within them'. Saunders et al (2007, p 112) point out that the term 'paradigm' is 'frequently used in social science, but one which can lead to confusion' because of the plethora of definitions. Paradigm is a way of examining social phenomena from which particular understandings of these phenomena can be gained and explanations attempted.' The phenomenon to be examined is the specific role reputation and trust play in the insurance decision making process. Although previous studies discovered that reputation and/or trust are part of the underwriting and broking process, they did not further examine these two phenomena in the London insurance market. Insofar, the specificities of these social phenomena need to be further explored, so that a better understanding can be gained.

Burrell and Morgan (1979) propose four main paradigms which can be used in business research:

- Radical humanist
- Radical structuralist
- Interpretive
- Functionalist

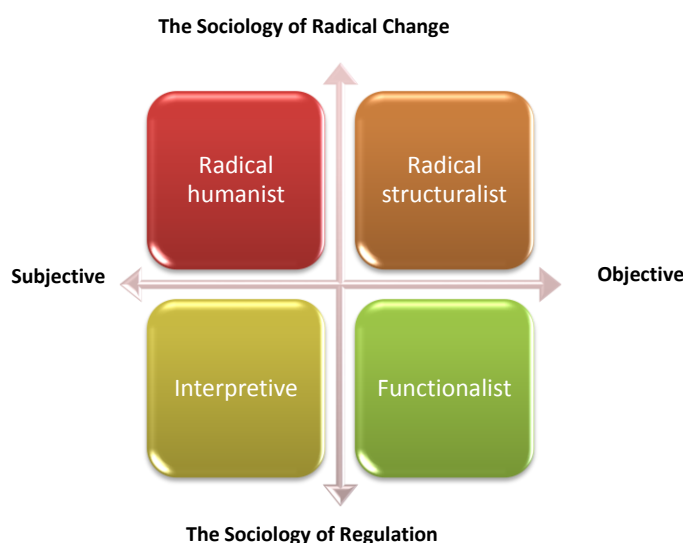


Figure 28 Research paradigm (Source: Burrell and Morgan, 1979)

Burrell and Morgan (1979) argue that these four paradigms should help researchers to clarify their assumptions about the nature of science, to offer a better understanding about researchers' approach to research and facilitate a pathway throughout the research. Apart from these four research paradigms, Burrell and Morgan (1979) introduced four additional conceptual dimensions:

- Radical change;
- Regulation;
- subjectivist and;
- Objectivist.

The two latter terms refer to ontological concepts, i.e. either an interpretivist (phenomenological) or a positivistic philosophy. The term 'radical change' implies that the researcher is critical about the way business or management is being organised and would come up with proposals to change affairs. The dimension accepts the existing framework, but would make proposals to improve affairs within this framework.

In respect of the above mentioned paradigms, the radical humanist is associated with the radical change and subjectivist dimensions, i.e. with a phenomenological approach which adopts a critical view on how organisations work including proposals to change the current framework. On the other hand, the radical structuralist paradigm follows an objectivist philosophy. Here the researcher would be concerned with organisational structure, such as reporting lines or hierarchies, by observing what is happening within an organisation rather than studying social phenomena.

The functionalist paradigm also follows an objectivist philosophy by seeking rational explanations for problems occurring in a business environment whilst also suggesting improvements to the organisational structure (Saunders et al, 2007). For Burrell and Morgan (1979) this is the mostly adopted paradigm for business and management research and Saunders et al (2007, p 113) argue that a functionalist paradigm is appropriate because 'organisations are rational entities, in which rational explanations offer solutions to rational problems.'

As the name suggests, an interpretive paradigm tries to interpret what is going on. According to Burrell and Morgan (1979, p 28), this paradigm aims 'to understand the world as it is, to

understand the fundamental nature of the social world [...].’ It also sees ‘the social world as an emergent social process which is created by the individuals concerned.’ (ibid)

For this thesis a functionalist or an interpretive paradigm could be considered. As mentioned above, a functionalist paradigm seeks rational explanations that can inform practical solutions to a problem. An interpretive paradigm seeks to understand how individuals behave in a certain environment (or social world). It would be possible to consider a functionalist paradigm by assuming that underwriting, broking or insurance buying decisions are purely based on rational factors (such as price and coverage). However, this would ignore the subjective elements of insurance decisions that are inherently uncertain by nature and can be driven by subjective factors, such as concerns about future claims paying ability or the risk attitude of the underwriter. In addition, the aim of understanding the specific role of the qualitative factors of reputation and trust in the London insurance market, lends itself more to an interpretive paradigm which will be adopted for this thesis.

6.5 Research approach

Saunders et al (2007) differentiate between two research approaches, namely the deduction and the induction method. Whereas a deductive approach is widely associated with research in natural science (Adam and Healy, 2000), the inductive approach is more used in social science which business research is part of. The deductive approach is also more linked to the positivistic research philosophy and the inductive to the phenomenological philosophy. In addition, the deductive approach is connected to quantitative research and the inductive ones to qualitative research (Greener, 2008). Saunders et al (2007) summarise the difference between deductive and inductive research approaches below:

Table 18 Major differences in research (Source: Saunders et al, 2007)

<i>Deductive research</i>	<i>Inductive research</i>
<ul style="list-style-type: none"> • Scientific principles • Moving from theory to data • The need to explain causal relationships between variables • The collection of quantitative data • The application of controls to ensure validity of data • The operationalisation of concepts to ensure clarity of definition 	<ul style="list-style-type: none"> • Gaining an understanding of the meanings human attach to events • A close understanding of the research context • The collection of qualitative data • A more flexible structure to permit changes of research emphasis as the research progresses

<i>Deductive research</i>	<i>Inductive research</i>
<ul style="list-style-type: none"> • A highly structured approach • Researcher independence of what is being researched • The necessity to select samples of sufficient size in order to generalise conclusions 	<ul style="list-style-type: none"> • A realisation that the researcher is part of the research process • Less concerned with the need to generalise

A deductive research approach seeks to test a hypothesis through the collection of data, while an inductive approach aims to understand what is going on (Hallebone and Priest, 2009). (Ng and Hase, 2008) argue that It is the theory that emerges from data rather than a hypothesis tested through data. In addition, the latter research approach allows analysing data concurrently (i.e. once interviews have been conducted) whereas an inductive approach requires data to be analysed once all data has been collected. For Collis and Hussey (2009) this research approach assumes that reality is independent of the research and the aim is really the discovery of theories.

However, positivistic research has been criticised for being too remote from the subjects being researched. There clearly is an argument that it is difficult to understand people without understanding their perceptions and motives (Collis and Hussey, 2009). In addition, trying to assign a statistical value might not reflect complex phenomena, such as, in relation to underwriting decision making or insurance broking. The advantage of a positivistic approach is that it allows the collection of a larger set of data (through pre-determined questions) thus facilitating comparison and statistical analysis (Patton, 1990). However, phenomenological research enables the in-depth study of phenomena, but it should be noted that they are not mutually exclusive. It is the suitability and aptness to tackle the research question which should be considered (Adam and Healy, 2000).

A deductive research approach normally delivers more reliable results through the data collected, subject to an appropriate sample size which means that there would be no significant difference in results if the study was repeated (Collis and Hussey, 2009). Qualitative data, on the other hand, is subject to interpretation, but reflects the phenomena being researched, thus providing a higher degree of validity (Collis and Hussey, 2009). Notwithstanding this, Greener (2008) acknowledges that quantitative research is very often associated with empirical testing, but argues that qualitative research is very much applied in social science. Saunders et al (1997)

add that a research strategy should be chosen on the basis whether it can answer the research questions, but also what resources and amount of time is available.

Research approach adopted for this study

To understand the role of reputation and trust in the insurance decision process in the London insurance market, the main objective of this thesis, requires a better understanding what underwriters and brokers associate with the terms 'reputation' and 'trust' in the context of decision making. As such, a deductive approach accompanied by a relatively high sample size might be difficult to achieve, especially given that previous researchers, such as Keykhah (2000) who looked into underwriting practices in a specific sector of the London insurance market, noted a reluctance of underwriters to be interviewed. Consequently, the aim of this study is not test particular hypotheses, but to adopt an inductive, phenomenological approach to get a better understanding of how reputation and trust interact in decisions about underwriting, broking and insurance buying in the London insurance market.

6.6 Research Design

Research design is concerned with how the research questions will be answered and as such forms the basis of a research project (Robson, 2002) which in turn is dependent on the choice of the research philosophy. For Saunders et al (2007) the research purpose, the research strategy and research methods are essential parts of the research design. These three parts will be discussed below.

6.6.1 Research purpose

Saunders et al (2007) link the research purpose to the research questions developed which would result in either descriptive, explanatory or exploratory studies. Descriptive research aims to 'portray an accurate profile of persons, events or situations' (Robson, 2002, p 59) which, however, ignores conclusion from the information collected. Explanatory studies aim to find out about causal links between variables (Saunders et al, 2007) which can be done through empirical tests, and as such they are more associated with an deductive research approach. Exploratory

research, on the other hand, aims to explore ‘what is happening; to seek new insights; to ask questions and to assess phenomena in a new light’ (Robson, 2002, p 59). It is particularly useful if the aim of the research is to understand a problem, especially, when there is uncertainty about the nature of the issue. However, this kind of research requires more flexibility as the research trajectory might have to be changed in light of new knowledge (Saunders et al 2007). For this thesis an exploratory research approach has been adopted in order to get a better understanding of insurance decision making in the London market and what role reputation and trust plays in this process.

6.6.2 Research strategy

Research strategy is sometimes termed research methodology as it deals with the understanding of research (Greener, 2008). The choice of research strategy will be guided by the research questions and objectives, but also by existing knowledge and research philosophy. However, Saunders et al (2007) also point out that there is no right or wrong when choosing a certain strategy and it is quite possible to combine various strategies, such as a survey and a case study even for a phenomenological research approach. Greener (2008) also notes that it is increasingly common for business research to mix research methods. Remenyi et al (1998) highlight that the choice of research strategy should also be driven by the skills of the researcher and see the following research strategies relevant for business research:

- Experiment
- Case study
- Action research
- Ethnography
- Archival research
- Grounded Theory
- Survey

Experiment is a classical type of research and is more linked to natural science, although in psychology this is also a common form of research strategy. The purpose is to establish causal links between variables and whether any changes in one variable has an impact on another variable (Hakim, 2000). Saunders et al (2007) concede that experiments in business research are rare due to the nature of research questions and the subject matter. There is also an issue

with the sample size as achieving a reasonable number of participants may be both costly and complex (Hakim, 2000).

A *case study* looks into a particular singular or multiple phenomena 'within its real life context using multiple sources of evidence.' (Robson, 2002, p 136) This differs from a survey (see below) as the amount of data which can be collected is limited.

Action research: As the name implies action research is a combination of research and taking action whereby a specific issue is being worked on (for example in an organisational context) and the researcher would be engaged with the practitioners to resolve the problems. In that sense the researcher becomes part of the organisation (Coghlan and Brannick, 2005).

Ethnography involves the researcher immersing into the environment which is being researched and also participating in activities, whilst at same time observing what is happening. Saunders et al (2007) argue that this can be very time consuming and thus it is not very common in business research. *Archival research* is not appropriate for this study as it involves the analysis of historical documents and records.

Grounded Theory

This research strategy is discussed in more detail as it is regarded as most appropriate for this thesis.

Bryant and Charmaz (2011) claim that Grounded Theory is the most widely used strategy in qualitative research. It is very often associated with inductive research approach (Saunders et al, 2007); a point which is also emphasised by Locke (2001) who sees the discovery aspect of research without a priori hypothesis building as a distinctive feature. Goulding (2002) considers this research strategy as very useful for business research where behavioural issues play a role and Locke (2001) agrees with this by adding that Grounded Theory is particularly useful in management and organisational studies which concern, for example, decision making. Grounded Theory involves the formation of an initial theoretical framework whereby data collection leads to theories which are then tested in further observations. Glaser (2001, p 5) is keen to emphasise this point by arguing that 'Grounded Theory does not generate findings: it generates hypotheses about explaining the behaviour from which it was generated.' Locke (2001) sees the bridging function between theory and practice as part of this research strategy as a further positive argument. This research strategy consists of an iterative process starting with a critical literature review leading to a refinement of the research questions. The advantage

is that data collection can start immediately as part of this iterative process (Glaser, 2001). However, Locke (2001) sees this as a possible constraint as the overlapping practice of data collection and analysis might slow down the entire research.

Surveys are often used in quantitative research as they allow the collection of a large amount of data in relatively cost effective way. This is even more apparent when utilising web-based surveys. However, Saunders et al (2007) point out that there is a practical limit to the number of questions that can be asked through a survey to avoid straining the goodwill of participants.

6.6.3 Research strategy adopted for this study

Based on the above descriptions and the outlined exploratory purpose of this research, a combination of grounded theory and survey was attempted. Largely qualitative data was collected through interviews, with a follow up by surveys through an appropriate questionnaire (see Chapter 8).

Harris and Brown (2010) point out that quantitative and qualitative mixed methods (such as questionnaires and semi-structured interviews) are often used to achieve a confirmation of results. However, Harris and Brown (2010) only examined the sequence questionnaires (surveys) followed up by semi-structured interviews, whereas this thesis proposed to start with semi-structured interviews followed up by surveys. Notwithstanding this, the advantage of using mixed methods is that different research strategies ‘may complement each other, overcoming weaknesses in individual methods.’ (Harris and Brown, 2010, p 12).

Onwuegbuzie and Leech (2005, p 7) assert ‘that a false dichotomy exists between quantitative and qualitative research.’ In addition, using mixed methods can help to reduce bias and increase the validity of research. Bryman (2006, p 97) points out that the combination of ‘quantitative and qualitative research has become increasingly common in recent years.’ Mixed method research can provide a plethora of data which the researcher might not have discovered with only one method.

The rationale for a combination of a grounded theory (via interviews), with subsequent surveys is twofold:

- a) To test whether the patterns emerging through semi-structured interviews are shared by a wider population of underwriters in the City of London in a more structured manner;
- b) To potentially overcome a disadvantage of semi-structured interviews, namely the problem of finding sufficient numbers of underwriters and brokers willing to be interviewed.

6.6.4 Choice of sample and data collection

Given the time restrictions and problems of accessing information when conducting academic research, it is rarely possible to collect data from an entire population (such as all underwriters or brokers in the London insurance market). Instead it is necessary to make a choice about a meaningful sample of this population. Saunders et al (2007) differentiate two main strands of sampling techniques, probability or representative sampling and non-probability sampling. Whilst probability sampling is more associated with quantitative research (Greener, 2008), non-probability sampling is very often used in qualitative research. Saunders et al (2007) point out that probability sampling is mainly used to make inferences about a population from the sample which means that the sample should be representative of the entire population.

Due to the exploratory nature of this study, non-probability sampling is considered as more appropriate and practicable. Greener (2008) argues that in qualitative research the focus is not making inferences from a sample to the population, but about understanding the data and building theories from the data. As such, even one interview might be sufficient. What is important is that the researcher has enough confidence in the validity of the results (Greener, 2008). Saunders et al (2007) also point out that in business research probability sampling may not be suitable to provide answers to the research questions. On the other hand, non-probability sampling techniques require some judgement about an appropriate sample size. Patton (1990) argues that non-probability methods are appropriate where the information collected and the subsequent analysis of data is more important than the sample size. Saunders et al (2007) identify a wide range of non-probability sampling techniques:

- Quota
- Snowball
- Convenience

- Self-selection
- Purposive

Quota sampling is non-random and is not dissimilar to probability sampling as the aim is to have a representative sample of the population. However, it is less granular as the quota sample is broader defined (such as all males working in Canary Wharf between the age 30-40).

Snowball sampling relies on the initially interviewed person(s) to recommend further interviewees and so forth, which can lead to a very homogenous sample. *Convenience sampling* implies that interviewees will be the ones which are easiest available (such as shoppers in Oxford Street for a consumer survey). Saunders et al (2007) point out that this sampling technique can become highly biased which means that conclusions are likely to be restricted.

Self-selection relies on volunteers coming forward to be interviewed which can have the advantage that interviewees are more motivated and thus generating high quality results.

Purposive sampling relies on the researchers' judgement on the sample size and the selection criteria. Saunders et al (2007) highlight that this sampling technique is particularly useful for a Grounded Theory research strategy, which this thesis is adopting. In summary, this thesis follows a purposive sampling technique with homogenous subgroups, such as insurance underwriters or insurance brokers active in the London insurance market. As the purpose of this research is to explore particular phenomena, namely the role of reputation and trust in the London insurance market, it was important to select underwriters and brokers with sufficient experience in this market and with a strong understanding of the dynamics of the face-to-face market place. As such, the judgement in obtaining an appropriate sample was to approach underwriters and brokers with extensive experience, and thus potential interviewees who are likely to be in managerial positions or have a high underwriting authority because of their professional experience (see section 6.7.2 for more details).

6.6.5 Collecting data

This research study calls for qualitative data collection methods. These can include interviews, questionnaires and observations. Given the limited existing research on this topic, primary data collection is necessary.

Observations could be considered for this study, as it is exploring behavioural issues and Saunders et al (2007) argue that observations are good way to watch what people are actually doing. However, as previously noted the London insurance market is very much reliant on relationship building and face-to face contacts. This means that in order to be able to make useful observations about behaviour, the researcher would have to totally immerse into the environment which would require having the same authorities as other London underwriters and the researcher would have to relatively quickly build up relationship with brokers and other market participants. Let alone the time limits of this study, this approach is not practicable as insurers are unlikely to grant these authorities just for this research. As Saunders et al (2007) point out this form of data collection can be very time consuming and is more appropriate where researchers work within their own organisation.

For the purpose of this *study interviews and questionnaires* are employed. Kvale (1983, p 174) sees interviews as part of research 'whose purpose is to gather descriptions of the life-world of the interviewee with respect to the interpretation of the meaning of the described phenomena.' Semi-structured and unstructured interviews are seen by Saunders et al (2007) as most appropriate for qualitative research. Unstructured interviews are by nature informal with no pre-determined list of questions. Greener (2008) notes that such interviews can go off at a tangent, which is viewed in a negative sense. On the other hand, this might be the point where the interview becomes interesting. Semi-structured interviews are based on a minimum set of questions which will always be explored. However, the interviewee is allowed to digress from the questions to areas of most interest to them. Greener (2008, p 89) sees this as a positive side effect since the 'focus of a qualitative interview is the interviewee, this is fine.'

Saunders et al (2007) highlight that there a potential quality issues with semi-structured interviews mainly the question of reliability, bias, validity and generalisability. The first and second issue concern the question whether other interviewers would extract the same information from the interviewees. There is also the issue whether interviewees respond differently to interviewers. The issue of genereralisability is acknowledged; however, as this is an exploratory study, it is not intended to draw general conclusions about the entire population. What should be born in mind is that non-reliability and bias will always be a risk when conducting qualitative research given the subjective nature. On the other hand, where the researcher has detailed knowledge of the industry or the topic which is being studied then the ability to probe and respond to interviewees' answer is extremely high which in turn increases the quality of the interview.

6.7 Arranging and conducting semi-structured interviews

6.7.1 Overview

The interviews were arranged by sending out letters or e-mails to senior personnel of insurers and brokers enquiring about the willingness to be interviewed on this topic. Initially, only ten underwriters were approached through letters to test whether this way of contacting underwriters would be successful. Three of these underwriters approached agreed to be interviewed. A thirty percent response rate could be deemed successful; however, given the time consuming efforts by the researcher to get either positive or negative replies, it was felt that other channels should be explored first. Further potential interviewees were targeted through the researcher's direct or indirect contacts in the London market and three additional interviewees were recruited through this channel. In respect of brokers, the major broker houses were contacted via e-mail. However, only one positive response came through this channel. All the other interviewees were also recruited through direct or indirect contacts in the London market. The same applied to the interview arranged with a representative of Lloyd's of London. As this organisation is not directly involved in underwriting, but responsible for overseeing the market place (see chapter 2), it was deemed sufficient to have only one interview with a representative of Lloyd's of London. In respect of the direct or indirect contacts in the London market it was possible to use some of the business contacts gained through the professional experience of the researcher. For example, a visiting professor of a business school who used to work for a broker firm was able to provide the researcher with broker contacts and a senior adviser at the then FSA arranged an interview with an underwriter in the London market. Another example is the attendance of an insurance seminar where by discussing the research project with a seminar participant it was possible to arrange further interviews.

Once a positive response was received, an interview date was agreed, and a more detailed list of topics was sent out to the prospective interviewee, together with the professional background of the interviewer, as well as an assurance that all information collection would remain anonymous and confidential.

The semi-structured interviews were mainly conducted in the interviewees' offices with the exception of one interview which was conducted in a coffee place in the City of London. Telephone interviews were considered, however, as Saunders et al (2007) point out the

significance of a face-to-face interview should not be underestimated. Firstly, senior personnel often prefer personal interviews over questionnaires. Secondly, it is easier to probe the interviewee and the researcher will be able to better ascertain whether the interviewee is trying to avoid questions. Easterby-Smith et al (2008) argue that semi-structured interviews are particularly helpful where the questions are complex and where the order of the questions is dependent on the response from the interviewee. In addition, the replies of the interviewees can be more personal (i.e. not a standard answer to standard question) and the interviewer can take clues from the way the interviewee answers questions. Saunders et al (2007) see semi-structured interviews as relevant for a phenomenological research approach. In particular, the ability to further explore concepts and ideas the interviewees came up with, and the opportunity to investigate other areas which the researcher had not previously considered, can assist in collecting 'a rich and detailed set of data' (Saunders et al, 2007, p 316).

Where possible the discussions were recorded; otherwise notes were taken by the researcher. The initial question for all interviewees was: 'What is your definition of reputation?' Depending on the response and in particular the clarity of the answer follow-up questions were asked. The topics listed in Appendix C are not exhaustive and as such additional topics were introduced depending on the trajectory of the conversation.

6.7.2 Data sources

Questionnaires and types of interviews

Prior to conducting the above mentioned interviews, an appropriate questionnaire for both underwriters and brokers was developed which included high-level questions and topics to be discussed. Due to the exploratory nature of this research the interviews were conducted in a semi-structured form.

A total of 12 semi-structured interviews were conducted, each lasting between 45 – 60 minutes. Six interviews were with underwriters of insurers active in the London market, one with a representative of Lloyd's of London, and five interviews with insurance brokers (of which one was a group interview with three participants). In addition, an interview was conducted with a representative of the Association of the Insurance and Risk Managers (AIRMIC) which, amongst others, represents corporate insurance buyers. As an additional data source, an unstructured

interview was carried out with a staff member of a global insurance group, who had conducted a research on the factors influencing corporate insurance buying in Germany.

In terms of the appropriateness of the sample size (six underwriters and five brokers), there is a wide range of opinions as to how many interviews are needed for qualitative research. Adler and Adler (2012) argue that it may be difficult to know how much data is needed to research the phenomenon. So, an appropriate sample may range from only one to hundred. Becker (2012, p 12) also highlights that there is 'no reasonable answer, no magic number you can do and then you're out of danger.' Furthermore, Becker (2012) agrees with Adler and Adler (2012) that even one interview could be sufficient and the decision to stop trying to arrange additional interviews will be somewhat arbitrary considerations, such as time or money. Denzin (2012, p 23) also supports the argument that even only one interview might suffice because the face-to-face interviews with a specific member of a community provides a 'set of cultural understandings currently available for use by cultural members.' Flick (2012) posits that the answer to the sample size question depends on the research question, but also the availability of potential interview partners. Charmaz (2012, p 22) also makes an important point about this issue by highlighting that researchers do not always appreciate other components of qualitative research they have conducted and 'mixed qualitative methods can strengthen a study with a small number of interviews.' Mason (2010) points out that the expertise of the interviewer can significantly influence as to how many interviews are necessary to uncover rich findings and answers to the research questions.

The individuals who were interviewed in this study all had significant experience in their field. This meant that they were able to consider the questions asked from different angles and also from the perspective of different classes of business. As such, it could be argued that the number of interviews conducted were sufficient to explore the research question. It should also be borne in mind that the research was conducted as a part-time study which means that the researcher's resources in terms of arranging interviews, conducting interviews and analysing interviews was limited.

The profile of the interviewees was as follows (at the time of the interview):

Underwriters

- Head of Property Underwriting
- Deputy Chief Underwriting Officer
- Head of Financial Lines

- Director of Underwriting
- Head of Reinsurance Underwriting
- Property Underwriter

Brokers

- Managing Director
- Vice President Latin America
- Chief Broking Officer
- Head of Crisis Management
- Head of Engineering
- Head of Reinsurance
- Chief Placement Officer

All the underwriters mentioned were from different organisations. On the broker side, the Head of Crisis Management, the Head of Engineering and the Head of Reinsurance came from the same organisation; all other brokers came from different organisations.

6.7.3 Ethical issues

The main ethical issue was the fact that the researcher was also in part-time employment with the Financial Services Authority (FSA) and later with the Prudential Regulation Authority (PRA). There was a concern that targeted firms in the London market, who are regulated by the FSA/PRA, might be reluctant to agree to interviews if they became aware of this circumstance. However, this issue had to be weighed against ethical standards required for this research. Consequently, once an interview was arranged a broad outline of the topics to be discussed was sent out to the interviewee, together with information about the professional background of the researcher, and a statement that the research is totally independent of the FSA/PRA. None of the interviewees withdrew the appointment after the employment information was provided.

Prior to starting the interviewing process, an Ethics Review Checklist was completed and the empirical research proposed was approved through the University of Southampton's ethics and research governance process.

Because of the professional background of the researcher (at the time of the interviews working for the Financial Services Authority), there was the potential for more restrained answers from

interviewees to the interview questions. However, all prospective interviewees were advised of the researcher's current employment with the FSA (and the lack of connection of the study with the FSA), consequently it can be presumed those underwriters and brokers who had concerns about the researcher's FSA employment would have declined to be interviewed. In addition, none of the potential interviewees who were approached and who subsequently declined did so because of this issue.

6.7.4 Problems encountered

Underwriters

Initially, letters (on a University of Southampton letterhead) were sent to a number of underwriters in the London Market asking for an interview on the research topic. Following from this, interviews were arranged at a convenient time for the interviewee. The quality of the interviews varied significantly, depending on how interested underwriters were in this topic and how involved these underwriters were in the day-to-day business. Some underwriters were reluctant to have the conversation recorded due to concerns about potential leakages, despite assurances that all information would remain confidential. These interviewees pointed to the Listing Rules of companies listed on the stock exchange, which require the release of inside information which might influence investors' decision to hold a share in a company (FCA Listing Rules 2013). This information includes notably financial performance, but also information in 'the course of the issuer's business' (FCA Listing Rules, 2013, DTR 2.2.6), which some interviewees might have interpreted as including the description of business processes within their organisations. Following the arrangements of interviews through letters, additional interviews were sought either via e-mail or through indirect contacts (for example, through business contacts). In general, it was relatively difficult to get positive responses to interviews; a fact also highlighted by Keyhkah (2000) despite being supported by the Association of British Insurers (ABI).

Insurance Brokers

Initially, brokers were targeted by contacting their investor contacts (as per their website) as it was difficult to find publically available information as to who was responsible for broking business in the London market. This proved to be challenging as only one broker responded positively. However, through the researcher's contacts in the City of London it was possible to

find a number of brokers who were willing to be interviewed. The majority of brokers were content with the interview being recorded.

Corporate insurance buyers

AIRMIC was approached with the expectation that this might facilitate interviews with corporate insurance buyers. The AIRMIC representative, who was interviewed, discussed the interview request with the relevant committee. None of the AIRMIC members was prepared to be interviewed about this topic; however, given the focus on the placing process in the London market, no further attempts were made to find interview partners from corporate buyers.

6.8 Web-based questionnaires for a survey

6.8.1 Overview

Saunders et al (2007) point out that questionnaires are widely used as part of a survey research strategy, but note that there are differing views as to what constitutes a questionnaire. For De Vaus' (2002) questionnaires involve asking the same questions in the same order to survey participants.

Questionnaires can include structured interviews and telephone questionnaires, but also online surveys where the interviewer is not present. Saunders et al (2007) caution that designing questionnaires is not as easy as it may initially appear. Because of the nature of the survey (e.g. anonymous online surveys) it is not possible to revert back to the individual who filled in the questionnaire and ask for clarification. This means it is important to ensure that the questionnaire will collect the appropriate information which achieves the research objectives

Greener (2008) concur that designing questionnaires is particularly difficult and highlight a number of issues which the researcher should consider during the design process:

- a) The format which should not be too long and not too difficult to understand;
- b) The question of how much personal information is necessary (e.g. gender, age, job experience);
- c) The proportion of closed and open questions;
- d) How the questions should be structured (e.g. tick box questions or scale questions)
- e) How much space is necessary for an open answer;

- f) Whether check questions are necessary to achieve consistent responses;
- g) How much information should be provided to the respondents about the aim of the survey.

Saunders et al (2007) argue that questionnaires are not that good for exploratory research, in particular where there are a larger number of open-ended questions. However, the authors also point out that questionnaires can be used to explore attitudes of customers which can be complemented by in-depth interviews. Conversely, Harris and Brown (2010) emphasise that mixed research methods, such as semi-structured interviews and questionnaires might be difficult to compare because of the way data is collected. The main attraction is that different research methods could complement each other and overcome the shortcomings of individual methods.

The internet is increasingly used for online surveys (Eysenbach, 2003); however, the advantages and disadvantages over more traditional survey methods, such as mail or telephone, need to be acknowledged (Wyatt, 2000). A web-based survey is 'the collection of data through self-administered electronic set of questions on the Web.' (Archer 2003). For Wyatt (2000) survey methods should be assessed by two main criteria: How data is captured and how survey participants are being identified. For Rhodes et al (2003) web-based data collection is a relatively simple process and Couper (2000) add that the cost of conducting the survey can be significantly lower than surveys carried out by sending mails or face-to-face surveys.

Rhodes et al (2003) highlight that if the intention is to collect behavioural data (such as for medical studies) there are a number of challenges and advantages which need to be considered. There are also ethical issues which should not be ignored. Apart from the cost-efficiency Rhodes et al (2003) identified a number of advantages and challenges for web-based surveys:

a) Advantages:

- **Electronic dexterity:** Web-based surveys can have the same function as other developed questionnaires, such as mail, self-administered and interviewer administered questionnaires. However, new questions can be easier added to an electronic format if preliminary findings or new information require a change in the questionnaire. In addition, a web-based survey allows for documenting the time it took to complete the questionnaire for further analysis.

- **Potential larger sample number:** Rhodes et al (2003) argue that web-based survey can overcome the traditionally low response rate for mail-based surveys as through the internet the researcher can reach out to a significantly wider audience. However, Eysenbach (2004) challenges this by arguing that compared to the visitors of a particular web-site the response is actually relatively low which raises the questions of the validity of the results.
- **Speediness of process:** For Rhodes et al (2003) the internet provides a more expedient method of collection data as respondents can access the web-site at any given time. Whilst this applies to web-based surveys accessed on private computers the same does not necessary hold truth for workplace surveys. Most employees will leave their laptop/desktop in the office, so will only have access to the survey during working hours. However, the roll out can be potentially be accelerated as survey can either accessed through a popular website or through a simple e-mail.
- **Better data:** Rhodes et al (2003) argue that because of the potential to include explanatory material (such as drop down menus) and the structured format of the web-based questionnaire there is less room for errors. With a paper-based survey participants can make invalid entries thus either having to go back to the respondent for clarification or ignore the answer thus reducing the population for a specific question.
- **Sensitive topics and the reduction of bias:** It appears that survey participants are more willing to answer sensitive questions in a web-based survey. Rhodes et al (2003) does not provide an empirical rationale for this attitude; however, assumes that respondents might feel more secure when answering questions through the internet.

b) Challenges

- **Sampling:** Because of the anonymity of the survey, sampling – even it is random – is difficult and response rates are difficult to predict. There is also the risk of multiple submissions by one or more participants.
- **Competition:** Given the inflation of survey request when opening a website (e.g. holiday booking sites or newspapers) it can be difficult to draw the attention to a specific survey request because of survey fatigue.
- **Measurement error:** Couper (2000, p 475) defines measurement error as ‘the deviation of the answers of respondents from their true values on the measure.’ Such errors could

arise from the behaviour of the survey participant or from the design of the survey.

Participants might

- lack motivation,
- might not fully understand the question,
- may interpret the questions and closed answers in an unintended way,
- might lack time, thus rushing through the survey,
- may deliberately answer the questions dishonestly.

In terms of the design of the survey, there is for example, the issue what web browser respondents use which can make it difficult to scroll through the survey. There are also limitations in respect of design capabilities of the survey software (such as Survey Monkey) which can impact how the survey is viewed by participants

Notwithstanding these challenges, Couper (2000, p 476) argues that ‘web-based surveys offer enormous opportunities for low-cost self-administered surveys using a wide variety of stimulus material.’

6.8.2 Design of the questionnaire

Although the semi-structured interviews provided rich data for this research, the limited number of underwriters prepared to be interviewed made it difficult to draw empirical conclusions. The web-based survey aimed to complement the former research method. It was hoped that a larger sample should provide better empirical evidence of the findings from the semi-structured interviews.

The questionnaire was designed using a data requirement table in a similar fashion as promoted by Saunders et al (2007). This data requirement table is shown in Appendix D. Fox et al (2002) highlight that for web-based questionnaires the wording of questions is even more important due to absence of support. The researcher should ensure that the respondents interpret the questions as envisaged.

The questionnaire was structured into three sections:

- A general section: which asks general and contextual questions in order to gauge whether/how underwriters understand the concept of reputation and trust.

- A more specific section: which asks specific questions about underwriters' view of the role of reputation and trust in a pre-defined event
- A personal information section: which asks personal information about gender, age group and professional experience whilst avoiding questions which would identify the respondent

The questionnaire was moved to the web-based platform, i-survey, developed by the University of Southampton with the intention to roll it out to underwriters in the London insurance market after the survey design and questionnaire was submitted and approved by the ethics committee of the University of Southampton.

The length of the questionnaires was driven by the desire to be able to answer the pertinent research questions and in the knowledge that underwriters in the London market have limited time (and potentially patience) to answer surveys. There is an expectation that they are most likely to answer the survey during their lunch break. The limited control over who will be answering the survey is partially alleviated by the fact that the survey targets underwriters in a very specific market which enhances the representativeness of the results (subject to a reasonable sample size).

6.8.3 Problems encountered

The main problem encountered was the low response rate, despite a number of attempts to find underwriters who were willing to participate in the survey. Initially, a survey request was sent to the previously interviewed underwriters. Most of them had been informed about the intention to conduct a web-based survey and they had agreed to support this by rolling the survey out to their colleagues. However, most interviewees did not respond to the e-mail request. One interviewee had moved to the United States and although the interviewee was supportive of the request, the office in London was not inclined to participate as they had just concluded a reputation related project. Another interviewee had moved to Germany and the London office was unwilling to cooperate.

There were also discussions with a consultancy firm who specialises in the London insurance market and publishes an annual ranking of underwriters based on survey amongst brokers. The company was initially very interested to incorporate the web-based survey questions into their own survey which would have provided a high sample size. Following a research presentation at

their premises it was agreed that the company would consider the best way forward. However, despite a number of e-mails to the contact person and left voicemails it was impossible to receive any feedback from this company, so this route had to be abandoned.

The Institute of Underwriters was also contacted to help with this survey. However, there was no positive response. Lloyd's of London was also approached, however; it was made clear that a participation in the survey would be a matter of each individual Syndicate. The last route was through an ex-colleague of the researcher who is involved in an underwriting forum in the London Market. The ex-colleague was very optimistic that the members of this forum could be swayed to participate in the survey and a reasonable sample size of approximately 30 could be reached. However, in the end only 6 underwriters participated in the survey and the sample is skewed towards underwriters below 30 years of age.

7 Discussion of interviews

7.1 Introduction

In the following sections the results of the interviews with underwriters and brokers in the London market regarding the role of reputation will be discussed. In addition, the findings of the interview with an AIRMIC representative regarding the role of reputation in the insurance purchasing process will be summarised followed by a discussion of the brokers' perspective on this issue. The chapter is structured as follows:

- 7.2. Definitions of reputation by underwriters and brokers
- 7.3. The role of reputation and/or trust in the underwriting and broking process
- 7.4. Other themes emerging
- 7.5. The role of reputation and trust in lead and follow underwriter decisions
- 7.6. The role of reputation in the insurance purchasing process
- 7.7. Conclusions

Sections 7.2. to 7.5. deal with responses from underwriters and brokers whereas section 7.6 deals with responses from insurance buyers and insurance brokers. Sections 7.3, 7.5 and 7.6 relate specifically to the main objective of this thesis, namely to identify how reputation and trust influences the insurance decision making process, with a particular focus on insurance underwriting and broking in the London insurance market and also covers sub-objective 6: To explore how reputation and trust influence decisions by underwriters, brokers and insurance buyers. Part of section 7.4 (sub-heading: Reputation and/or trust to reduce decision time?) relates to sub-objective 7: To investigate whether there is evidence that reputation and/or trust could be utilised to reduce the complexity of underwriting and broking decisions.

The sub-heading: 'Sanction/approval role of reputation with impact on trust' of Section 7.2 covers the additional objective: The consequences for business relationships between underwriters and brokers as a result of a negative reputation, as outlined in the Abstract.

The research studies discussed in Section 5.3 have already provided some indications about the importance of reputation and trust between underwriters and brokers in the London market, but the interviews should present more specific details on how these market participants interact and how reputation and trust influences decisions. Before summarising the findings of

the interviews the following assumptions about reputational relationships are summarised below:

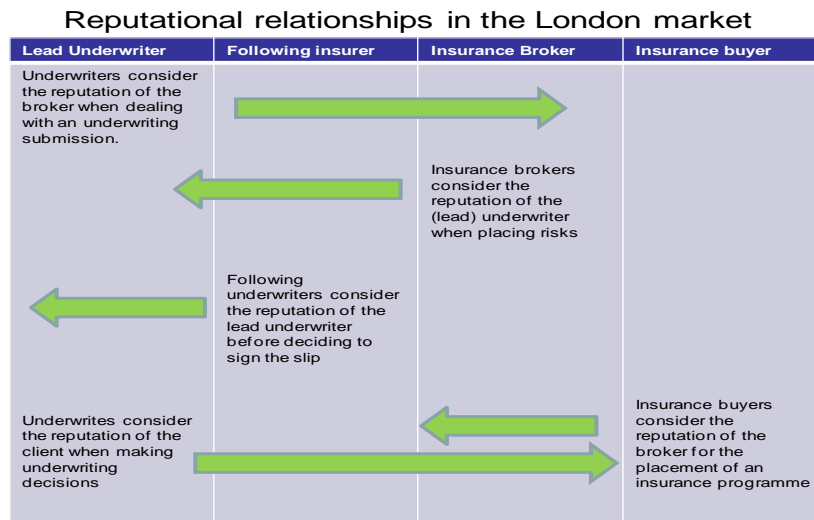


Figure 29 Reputational relationships in the London market (own diagram)

7.2 Definitions of reputation by underwriters and brokers

The answer to the question of what constitutes reputation varied by interviewee and there is no overall agreement on the function of reputation. However, all interviewees had a relatively clear view about reputation and its importance in the London Market. Below are the answers to the question how reputation is being defined, split between underwriters (including Lloyd's representative) and brokers:⁹

Table 19 Sample of reputation definitions provided by interviewees

'Reputation is what third parties think of an individual or a company. How an organisation is perceived and whether an organisation is trustworthy.' (U1)
'[...] is about how outsiders see a company or an underwriter. It is outside your control, but you can try to improve it. It is influenced by how you handle claims, how employees behave or interact with others and it is also about brand.' (U2)
'[...] is about the image you have from someone in the market. It is about the quality of service and the product you offer. The strength of the brand plays a big role. In the end it is more or less about product quality.' (U3)

⁹ U_n = denotes underwriters and B_n = denotes brokers

'[...] can be seen in a number of different ways. Overall, it can be defined as the overall impact an organisation has in the market. It also describes the role the organisation perceives to have.' (U4)

'Reputation means that individuals or firms are trusted. This can be positive in the sense of providing complete information. It also involves a straightness of information or good claims service.' 'Reputation can be driven by an individual's behaviour. If someone is a bit sharp or close to the wind this can influence the broker/ underwriter relationship.' (U5)

'Reputation means that brokers associate certain expectations with [the insurer xx – anonymised]' (U6)

'I think there are two things here: One is the reputation and the other is the perception of reputation. There is a difference between wholesale and retail insurance. [...] In the wholesale market, actual behaviour influences reputation whereas in the private consumer market it is about whether you feel good about this insurer or not and who is the cheapest.' (U7)

'Reputation is a validation process, it is based on experience. It is something which is established over time. It is a validation process of integrity and honesty which is also based on the skills to present things in an honest way.' (B1)

'Primarily it is about the ability of an underwriter, but also the company he works for. The factors influencing reputation are his experience his knowledge and his ability to transact and to trade. Also, the quality of the underwriter and the service provided by the underwriter are important.' (B2)

'I think reputation is entirely capricious; the destruction of reputation is entirely unpredictable. [...] Individual underwriters have a reputation. The reputation of the underwriter will affect the amount and the quality of business they get. If you have an underwriter "who is a pain in the arse", he or she is unlikely to show better business.' (B3)

'Reputation is a bundle of soft and hard information about a person which designates past behaviour and predicts future behaviour. It not just what's been written about him; it's about the whole network for someone in the London market which is a very close community. People know lots about people and people talk a lot about people. Some is correct and some is not and some is factual and some is not. So reputation is a whole bundle of stuff.' (B4)

'Reputation is how other people perceive your company, the trustworthiness, efficiency or service.' (B5)

There are potentially a number of messages which can be construed from the quotes in Table 19. Firstly, reputation is often seen as a perception of individuals or companies rather than a judgement, as argued in Chapter 3. However, it should be noted that underwriters made a linkage between prior actions and the perception, such as in the quote 'reputation is influenced by how you handle claims'. As such, it is not clear where the interviewees see reputation in the decision making process. Some of the above quotes would support Rayner's (2003) definition of

reputation as ‘a collection of perceptions and beliefs, both past and present, which reside in the consciousness of an organisation’s stakeholders – its customers, suppliers, business partners, employees [...] and the public at large.’

The definition of B1 suggests that brokers understand the need for underwriters to receive all the information necessary to accurately evaluate and price a risk. If risks are not presented in an ‘honest’ way, underwriters may set the wrong rates or wrong terms and conditions which in turn will have implications for the reputation of the broker. The second definition is less judgement based, but is oriented on the functions of an underwriter or broker. Interviewee B2 pointed out that one reputational factor is integrity, and if an underwriter has doubts about the integrity of a broker, he/she may refuse to deal with a certain broker even if he continues to deal with brokers from the same broker house. Vice versa, brokers would also refuse to deal with certain underwriters if there are doubts about their behaviour. For example, if an underwriter tries to avoid claims payment on a permanent basis this could result in underwriters not seeing any business from a broker.

Interviewee B1 also highlighted that brokers and underwriters alike *‘may try to enhance their own reputation’* and they may *‘purport that they can provide a level of service or a price which they cannot meet. It is about delivery of something they promised.’*

Consequently, if they fail to deliver reputation may be damaged. Conversely, reputation may grow if brokers and underwriters can actually deliver. For Interviewee B5 recent events have heightened the risk of a damaged reputation and the larger brokers are concerned about this. Fines to brokers by the FSA were mentioned as reason for a damaged reputation.

7.3 The role of reputation and/or trust in the underwriting and broking process

*‘Brokers [in the London Market] are lazy; they only go to the underwriters they know’
(Underwriter)*

‘If an underwriter is a pain in the arse he will have limited access to good business’ (Broker)

The above quotes illustrate candid views expressed by an underwriter and broker. The first one points to the reputation of brokers in the London market and the second points to the sanction function of reputation. In this section, the interviews with underwriters and brokers regarding

the specific role of reputation and trust will be discussed. The answers have been grouped into two function categories of reputation and trust as discussed in chapter 3:

- Information/signalling role of reputation;
- Sanction/approval function of reputation and its impact on trust.

Other themes emerging are discussed in section 7.4.

General acknowledgement of a role for reputation in the underwriting and broking process

The role of reputation in the underwriting and broking is generally acknowledged by both underwriters and brokers. A number of participants made a particular argument about the London insurance market place where face-to-face contact is still regarded as an important factor. This has to do with the proximity of underwriters and brokers in the City of London, but also with the more complex and unique risk being placed in the London insurance market.

The interviewed underwriters acknowledge that reputation is an important factor for brokers when placing business. Here the behavioural aspect comes into play as brokers would make a judgement about how an underwriter dealt with issues in the past and following from that reputation is formed. A sample of responses illustrates this:

‘Reputation is influenced by how you handle claims, how employees behave or interact with others. Brokers would move business when an insurer has a bad reputation for bad claims handling.’(U2)

‘Reputation can be (negatively) impacted when an insurer does not respond adequately, where there is no serious underwriting or when claims handling is unsatisfying. In addition, behaving in the market aggressively is a factor.’(U4)

‘Reputation can be decisive when brokers make decisions about who to award business. There were cases where an insurer [...] gained business despite being more expensive.’(U6)

Information/signalling role of reputation

The competency of underwriters as an important factor for brokers was highlighted by interviewee U1 by describing the placing process in the London insurance market:

'Brokers would normally do a presentation to insurers to see who is willing to participate. However, there will be a selection criteria [by brokers], for example the ability to write these kind of risks and the ability to shoulder these risks.'(U1)

Another underwriter highlighted that

'brokers want competent underwriters with rational responses. Underwriters should have a good level of understanding of a complex class of business. Brokers are typically interested in price, terms and conditions and claims handling when it comes to the reputation of underwriters.' (U4)

Interviewee B1 emphasised the importance of personal relationships between brokers and underwriters. Here the ability to find out whether the broker is dealing with the appropriate underwriter and vice versa should not be underestimated. An appropriate underwriter or broker is a person who has the capabilities either to underwrite or place a particular risk in the London market.

The build-up of reputation through knowledge or competence was a common thread throughout the interview with B2. The interviewee also concurred with what underwriters were saying that there is a correlation between face-to-face negotiations and reputation. In the retail sector reputation is seen to be less of an issue; price is much more a decisive factor when making decisions. However, this could easily change once policyholders experience the claims handling practices of insurers.

Interviewee B1 highlighted the need for brokers to understand the market in order to place the business for the client. Brokers will have a good understanding what underwriters are capable of, which in turn is the basis for the selection of a certain underwriter. However, the need to understand the risk appetite of underwriters was also mentioned as a selection criterion.

Interviewee B1 also emphasised that the value-added service of brokers consists of an initial risk assessment and trying to understand the client's needs in terms of insurance cover. Following from this, brokers would have a good idea about potential underwriters. Very often underwriters for specialised classes of business would have university degrees with a focus on the specialist subject. For example, an aviation underwriter might have a degree in engineering which enables underwriters to thoroughly evaluate the potential pitfalls associated with the risks presented by the broker.

Interviewee B1 also pointed out that the experience of underwriters would be revealed through pricing, as underwriters who do not understand the risk presented either overcharge or undercharge. Subsequently, this can lead to consequences in terms of claims handling as underwriters who have undercharged for the risk may refuse claims or argue with the broker that they did not (fully) understand the risk or that they were not (fully) informed about potential problems. This behaviour can also create good or bad reputation. For Interviewee B5 the experience of the underwriter is also critical point, but at the same time claims services is a decisive factor. The interviewee also pointed out that the London insurance market has a very good reputation for being able to place complex business, but Lloyd's of London has a reputation for paying claims very slowly. Brokers therefore have to strike a balance when placing risk in the sense that they need to find the capacity (i.e. underwriters) which may not always be easily available whilst being conscious that the client expects expedient claims handling when a loss occurs.

Interviewee B4 pointed out that there are rational factors which influence a broker's choice, such as the financial strength of an insurer, what size of line they can underwrite or whether they competitive in terms of pricing. However, the interviewee argued that this would be a very simplistic approach as there are behavioural issues influencing the choice. For example, there are underwriters who have an academic approach to assessing risks and they may have the advantage of being able to see all risks which are being brokered, as brokers appreciate the way underwriters deal with submissions. There are other underwriters who are very good in dealing with brokers and these underwriters generally want the brokers they get on with to succeed. The relationship between brokers and underwriters goes straight into the heart of any human relationship as there is an overlay of the whole social interaction. Notwithstanding this, there is always the competition issue and there will be underwriters who will always compete on price and there will be brokers who will show them business because they know price is the driving factor. In summary, the hard and soft factors in the London Market can be very complex depending on the type of underwriter, the type of broker and the type of client.

Interviewee B4 was asked about the differentiating factor between an underwriter with expertise and knowledge and an underwriter who aims to undercut competitors when it comes to new business. The interviewee came up with a unique way of describing underwriters in the London market:

'If you look at these behavioural issues, not so much as behaviour but as sophisticated

filters [...]. There you can see an underwriting strategy as well. So some underwriters will always try to cherry pick the account; they only want to deal with the best risks, and at face value, that appears to be a sensible strategy. The danger of that is that the only risk they get to see are the risks no one else will write. They think they are cherry picking, but they are cherry picking out of a pre-selected portfolio.

But there are other strategies: One, I could be lavishly entertaining the brokers. Lots of golf days; Lots of racing. In a male dominated market, I could have the most attractive female underwriters. Irrespective whether they write very much. You know what, every broker will show them every risk they have. You could also go for the smart underwriter. You could sit down with any broker and teach the broker a lot about that risk. Even if he doesn't write it. The broker would always go to him because they feel they are learning something and they become better brokers.

Another strategy could be to write only a "bloody great line size" because brokers will come and see me and I can write the whole business, or at least I can drive the price for anyone else.

Others might get cheap insurance for a while. Another would be that every tenth day I would write several risks for a really cheap price for a number of brokers, even if he loses money. The expectation is that brokers would go back to their offices and say o my god this underwriter gave me this very low price I must bring other risks to him.'

Sanction/approval role of reputation with impact on trust

The nature of the London market and the importance of face-to face relationships has also been emphasised by brokers. Interviewee B1 highlighting the critical role reputation has in the London market for all market participants. In the view of interviewee B1 reputation can make or break business. A quote from B1 also highlights the connection between reputation and trust which is considered as paramount for the London market:

'[...] business is based on trust; the business is about integrity which contributes to reputation. If you overstep the mark this damages the reputation and hence the trust [...] because relationships underpin the business. [...] There is a huge amount of information being shared between underwriters and brokers which is critical for risk assessment. The information can be presented in different ways because they are human beings. There is pressure to make money and there is pressure to close a deal, so reputation and trust are important in these transactions'.

Interviewee B4 concurs with interviewee B1 about the role of reputation in the broking process, but also highlighted that the longevity of relationships is crucial as it enables people in the market to move between companies (both underwriters and brokers alike). Because of the proximity of the market, reputation can be carried over to the new company as it 'permeates and is a prelude to new dealings.'

Interviewee B4 also emphasised the sanction mechanism of reputation by pointing out that brokers who attempt to lie to underwriters will one day be caught out, and from that moment the broker will be a 'marked man' and underwriters' trust would have diminished which in turn would limit the ability of a broker to do deals with an underwriter. This can be crucial when a broker is under pressure to place insurance cover at the last minute (for example, late Friday afternoon). So a broker might approach an underwriter in the London market asking for immediate cover with the plea:

'Look I am fairly certain about the security. I know the client I haven't got all of the information, but it's gotta be done tonight.'

If the broker has a good reputation then it would be easier for an underwriter to provide insurance cover because he can trust the broker. However, if the broker has a reputation for 'always telling a pack of lies' the underwriter might turn to the broker: *'I need all of that in writing and I need it signed off before I can even think about.'*

Interviewee B1 was also asked why reputation and trust are mentioned more or less simultaneously and admitted that the connections between these two concepts are not clear. The interviewee was adamant that both concepts matter, but there was a suggestion that trust (or mistrust) might be the driver of reputation and not the other way round, as argued earlier in Section 3.7. Notwithstanding this, B1 emphasised the critical role of reputation a number of times during the interview.

Interviewee B4 also provided an explanation of the correlation between reputation and trust by saying:

'So trust is a by-product of reputation and that plays a big part in the London market. I think in any market place not just London, but I think across the piece. That in a way is a feature of repeat sale. If you have to sell things to the same people year in year out. It's not like selling double-glazing where you can disappear. This is a guy you gotta get back to today, tomorrow or whenever, so reputation is incredibly important.'

A number of underwriters pointed out that the reputation of brokers vis-à-vis underwriters is an important factor when making underwriting decisions. Brokers with a bad reputation may find it difficult to place business in the London insurance market. This can go so far that underwriters refuse to see brokers who have a negative reputation for being incompetent, for providing incomplete submission or for trying to place risks with inaccurate representation of the risk. As a result, brokers may have to revert to incompetent or inexperienced underwriters who might be happy to write the business, but who will create difficulties when claims are being notified. This in turn, can influence how clients view the broker and they might question why they placed the business with this specific underwriter.

On the other hand, there was an acceptance that underwriters will always come across more difficult brokers and such brokers have to be dealt with in a professional manner. Whilst this is a truism for most professions, it can be assumed that underwriters will deal differently with brokers who have a reputation for being difficult and that risks presented by a 'difficult' broker will be assessed in different manner, i.e. there is likely to be more scepticism when such a broker tries to place a risk. In addition, U6 felt that brokers have a tendency to present the risks they want to place in the best possible light and inexperienced underwriters can easily fall into a trap, i.e. they inaccurately assess the potential risks for the insurer. It is therefore important that underwriters ask the right questions when the broker explains the risk which he/she is trying to place. This image of presenting risks in the best possible light lead interviewee U6 to compare brokers to 'used car dealers.'

Where underwriters and brokers trust each other there is a greater inclination to support each other. This could mean that underwriters would accept risks from a broker which they would not normally write ('could you do me a favour' approach). This would also depend on whether the overall portfolio which broker has placed with an underwriter is profitable. In turn, there is also the expectation that brokers would place other – more favourable – business with the underwriter to compensate or as a reward for the above mentioned behaviour.

Interviewee U7 was more sceptical about the underwriter/broker relationship by saying that

'I [...] would always say to my underwriters that one should not trust a broker'.

It was highlighted by Interviewee U2 that underwriters may refuse to see brokers who have a bad reputation for presenting risks. However, Interviewees B2 and B3 also pointed out that this may happen the other way round, i.e. where brokers are disappointed with the behaviour of underwriters. For example, an underwriter may verbally accept to write a certain risk, but later

reneges on this deal thus forcing the broker to find another lead underwriter which may be time consuming, but also difficult for highly complex risks where capacity is limited.

Interviewees B2 pointed out that honesty towards underwriters is an important factor as there will be situations where a broker cannot achieve what he wished for and might need the help of the underwriter to get capacity or the cover required.

'[Honesty] increases the chances that the underwriter will oblige to your request. However, if you have a reputation as not being honest, tapping underwriters or being shady you won't get very far.'

7.4 Other themes emerging

Reputation and/ or trust to reduce decision time?

U2 was asked whether there were cases where reputation and trust impacted the decision regarding the assessment of risks, U2 replied that there was an instance where a broker had produced a very lengthy submission and U2 didn't want to go through the entire submission. Consequently, the interviewee asked the broker to explain the salient points, but this would not have happened with a broker U2 could not trust.

Interviewee U5 agreed with this by acknowledging that reputation plays a role when brokers present a risk and there is an expectation that a competent broker points out the salient issues in the submission. Underwriters will also rely on brokers' assurances when a risk is being presented. Underwriters cannot go through all the pages in a submission and therefore have to rely on what the broker describes. Even where insurers use an underwriting committee to make decisions, the reputation of the broker plays a role and the way a broker presents the risk to an underwriter influences how the underwriter presents the risk to the underwriting committee or the management.

Interviewee U7 pointed out that where an underwriter has dealt with a broker for a long-time and the broker's behaviour has always been good, then the underwriter might just ask verbal questions and rely on verbal answers from the broker without scrutinising the entire submission document.

Limits to the role of reputation - Pricing

The quotes in the previous section demonstrated that the role of reputation in the London insurance market is generally acknowledged. But what about pricing competition? Judging from the responses to the question, there is no clear cut answer to this, especially whether underwriters can charge more if they have a good reputation. Notwithstanding this, it appears that where underwriters can create a competitive advantage through a reputation for being able to write complex risk and handle (complex) claims, pricing is a factor, but not a decisive one. However, underwriters cannot go over the top, i.e. charging significantly higher premiums than competitors, even when they have a strong reputation in the market.

This also has to do with the fact that the London market is generally regarded as a specialist market where underwriters need to acquire the necessary qualification and knowledge to deal with complex risks. This means that there are a number of specialist underwriters who can write the risk thus keeping competition alive. That's why it is difficult to create a monopoly in the market unless there is only one underwriter left to write risks which others are not willing to accept. Moreover, brokers would probably infer from such a situation that claims handling is unlikely to be satisfactory hence would become very cautious when placing a risk.

Underwriters also pointed out that there is also a difference between renewable risks, i.e. where the existing underwriter is keen to renew a policy and a new risk, i.e. where an underwriter is asked by a broker to either to quote for totally new risks to be placed in the market or an existing risk which a broker is looking to move to another insurer. U2 argued that when it comes to a renewable policy, a good reputation allows for some upwards price flexibility between 10 and 20 percent. However, for new risks and for risks which a broker is keen to move to a new insurer pricing is a decisive factor, although this will also depend on the competences of the underwriter. This factor limits to some extent the influence of pricing in the decision making process of brokers. Notwithstanding this, the competition amongst brokers will always put pressure on underwriters to reduce prices for renewable risks as intermediaries have to justify their existence. If brokers cannot prove to clients that they had a tough negotiation with the insurer they could lose the business. This combined with the size of the three global broker houses has – in the eyes of a number of underwriters – created a constant competitive environment which to some extent has replaced traditional underwriting cycles (see section

2.3.2). Whereas hard underwriting cycles meant a general increase in prices, this is now limited to certain pockets where a major catastrophic event leads to a reduction in capacity, such as after the Japanese earthquake (Guy Carpenter, 2012).

Interviewee U6 pointed out that whilst the London insurance market is mainly a subscription market (see Section 2.7), a good reputation sometimes enables a (re)insurer to achieve higher prices than other insurers on the slip (although this only applies to excess of loss reinsurance). U6 used aviation reinsurance as an example where this has been common practice for a while.

Excess of loss reinsurance means that underwriters take a layer of the risk, which can be priced differently for each layer.

Table 20 x/s reinsurance example (Source: Kiln and Kiln, 2001)

<p>Example: Reinsured seeks a protection of up to £10,000,000 with an excess of £1,000,000 in three layers:</p> <p>1st layer: 1,000,000 in excess of 1,000,000 (deductible)</p> <p>2nd layer: 3,000,000 in excess of 2,000,000 (first layer plus deductible)</p> <p>3rd layer: 5,000,000 in excess of £5,000,000 (first layer + second layer)</p> <p>In case of a claim the second layer or second reinsurer would only pay if the claim exceeds 2 million. (Example based on Kiln and Kiln, 2001)</p> <p>Quota share reinsurance means that underwriters take a percentage of the whole risk.</p>
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Based on the argument of interviewee U6 the first layer could be priced different from the 2nd layer and the 3rd layer could also have a different price structure, depending on the reputation of the underwriter. However, this is not necessarily only driven by reputation, but by recognising that the lead insurer should get compensated for the additional work (e.g. negotiating the terms and conditions, issuing the policy, claims handling).

A number of interviewees also highlighted the differences between the retail market and the London market in respect of the ‘price’ which plays a paramount role in the former segment. This is very much the case in the United Kingdom where price comparison websites (such as GoCompare) make it easy for retail customers to find the cheapest insurances. Retail customers in the United Kingdom are generally more price sensitive than in other countries whereas in

other European countries, such as Germany, other factors, such as sales support rank higher (IBM, 2008). Notwithstanding this, interviewee U7 pointed out that even if retail customers are price driven, insurance buyers would not necessarily go for the cheapest. They are unlikely to choose an insurer they never heard of even if this firm is on top of the ranking list on a comparison website. They are more likely to insure with an insurer with a good 'brand' name which suggest a better reputation.

In general, brokers acknowledged that insurers have to earn money, but B1 also emphasised that price sensitivity depends on the insurance segment as well as individual preferences by clients. B1 thought this to be similar to the food sector where the majority will go to the major supermarkets, but there will always be buyers who prefer to shop at Harrods. Where underwriters have a reputation for understanding a specific industry (e.g. oil industry) or where the insurer provides good claims handling service there is less price sensitivity by clients because they appreciate the services provided.

The specialist function of the London market provides to some extent a competitive advantage vis-à-vis other global (re)insurance centres, such as Bermuda, Zurich or Munich. Interviewee B1 highlighted that the need for specialist knowledge, and hence underwriters who have the expertise to write complex risks, is benefiting the London market. Despite a growth in demand for insurance in Asia, in particularly in China, insurance expertise in these markets is still short in supply which means that the London market is still a major hub for underwriting risks stemming from this area.

In terms of competition, B1 acknowledged that overcapacity puts pressure on prices. However, this is more pertinent in classes of business where insurance capital can move in and out quickly, such as cover for natural catastrophe risks. The current low interest rate environment encourages investors to find alternative investments, and insurance is one of them. However, where specific expertise is required, market cycles are less relevant, because it is more a question who can actually write complex risks. Pricing in such insurance segments plays a role, but the limited capacity has a dampening effect. For interviewees B2 pricing really depends on the economy. They acknowledged that in the current climate it would be very difficult for an underwriter to show he/she can add value and thus charge a higher price. He/she really has to be very close to what all others are charging.

According to Interviewees B2, the choice of underwriter is also affected by the pricing environment:

'We have saturation in our market, we have overcapacity. We are in a situation where you go to an underwriter with the least resistance. For example, if an underwriter asks you 50 questions and the other does not than you go to the underwriter who just gets things done. If the price is the driving force then options are limited. The product as such is not inferior; all underwriters will offer the same products as long as you don't place it with a Mickey Mouse insurer or a 'C' Rated market. If you get it done within a credible market, the least point of resistance is where I would go.'

Interviewee B1 also pointed out that the Lloyd's Franchise Board (see section 2.3) has instilled more discipline into the market by introducing controls which ensure that underwriters do not move into new classes of business which they do not understand or where there is already significant overcapacity. As a result, market cycles might be longer and shallower. More importantly, the interviewee highlighted that the controls and governance regime implemented by the Franchise Board led to an absence of 'mavericks' in the market.

Interviewees B2 offered their specific view on how pricing and the knowledge of underwriters might interact:

'Price is key. Price will always be an important factor. However, there is an interesting dynamic. The least knowledgeable underwriter may come with a very competitive price. However, these days it is much more systematic than it used be to. At least in the Energy sector where I work there are much more internal guidelines, much more modelling because of the natural catastrophes happening. There are much more things happening before a baseline is determined. It is much more regulated than in the past. However, the ability and the knowledge of the underwriter to underwrite is still critical. We would certainly make clear to the clients the positives and negatives of the individual underwriter not just the company he works for. But most of our clients come and meet the underwriters, so they can form their opinion of the underwriters, but they are able to write the clients' programmes.'

Questioned about when the balance tips between reputation, relationship, and price, Interviewee B4 answered that brokers will be guided by what the client requires and to some extent the broker's behaviour reflects the intention of the client:

'If a client is only interested in price, for example in certain geographies and in certain classes, price and coverage become the only denominator and at the point a broker will find out who will write what, but ultimately it is going to be the price which determines the underwriter.'

But there are other classes, things like financial institutions, professional indemnity, D&O those sort of long-tail classes. There, the wordings are always complex and convoluted and are open to interpretation. So, if you want to have your claims paid that therefore requires the goodwill of the other person [underwriter] and in these classes relationships between the client through the broker and underwriter become very important. These are long-term relationships over 5 or 10 years

The fact there is an annual renewal, the broker serves a slightly different role. That is if two people have a close personal relationship. The broker's role is to manage this relationship. So the broker's role is to facilitate that relationship between the client and the underwriter and find a price level where both parties can live with [...] and nobody feels unhappy about it. So there is all sort of interplay and relationships and trust. That is sort of classic shuttle diplomacy to intermediate as supposed to someone who is a champion on a big white horse who is going into battle and carve up the enemy for the sake of his client which is a very aggressive style without any fear of the consequences to what happens there after. Those are two extremes.'

Are brokers lazy?

Interviewee U6 claimed that brokers are inherently lazy which means that they only approach a limited number of underwriters in the London market. Interviewees B2 vehemently disagreed with this. They argued that there is a lot of competition in the market which forces brokers to explore the market. For example, in energy there is a need for large capacities due to large sums insured involved and the high exposures. This means that brokers really need to use the whole spectrum of the market.

The same applies political risks where a single client may need a capacity of £200 million sums insured for terrorism risk which is approximately 10% of the worldwide capacity. This means that brokers have to use all the available capacity in order to achieve 100% coverage for the client. Notwithstanding this, underwriters need to convince brokers why they should be recommended to the client. In their view, it is not good enough for an underwriter, for example, to claim that they have been going for the last 15 years; that they have a number of branches and they pay claims. All underwriters are coming up with a similar argument. However, clients want to see how underwriters and brokers differentiate themselves. There is a view that competition in the broker community is much bigger than amongst underwriters, so the argument of laziness is not valid. Brokers have to constantly offer new solutions to the clients,

but this is made difficult by the fact that underwriters are not very innovative and ideas for new products or new covers have to come from the brokers.

Challenged that the London market as a 'close knit community' does foster stronger partnerships between brokers and underwriters, Interviewees B2 pointed out that the risk appetite of the underwriter is a crucial factor when it comes to the decision as to which underwriter should be approached. If brokers have a clear idea what risks underwriters want to write that makes it easier to place business with them as opposed to underwriters who just say 'maybe'. In general, participants in the London market talk to each other and if it transpired that a broker avoids certain underwriters this fact is circulated very quickly and the broker would be under pressure to explain.

Market power of large brokers

Interviewee U5 agreed that the bad reputation of a broker can lead to an underwriter's refusal to see the broker. However, the interviewee made the point there is a difference between dealing with the large global brokers and smaller or medium-sized brokers. The volume of business these global brokers bring into the London market is enormous and underwriters cannot avoid dealing with them. For smaller or medium-sized brokers, the reputation plays thus a bigger role. This means that the larger brokers can survive bad events for much longer (such as being fined by the FSA see below) because there is a presumption that these brokers can deal with these issue more effectively whereas smaller brokers may not be able to clean up their act. Interviewee U5 also mentioned that a specific larger broker has a bad reputation for claims handling, for example, being slow when dealing with enquires from insurers or delaying the payment of claims. However, U5 acknowledged that is difficult to avoid them when it comes to accepting new business.

Client money and breach of regulation

Another aspect which was introduced by interviewee U6 was that relationship between underwriters and brokers is also financially driven. As highlighted in Chapter 2.5 one of the functions of intermediaries is to collect premiums from clients and pass it on to insurers (after deducting commission). In addition, brokers are involved in the claims process and pay out claims to the policyholders (i.e. the money the brokers receive from the insurer). Interviewee

U6 pointed out that any failure by the broker to deal with clients' money appropriately can also have repercussions for the reputation of the insurer vis-à-vis the client. This is not much of a problem in the United Kingdom where the Financial Conduct Authority's (FCA) rules are very strict. The Client Assets Sourcebook (FCA, 2013) requires insurance brokers to separate clients' money from other (operational) cash, so that in case of insolvency can be rescued from the broker's accounts. In other countries, such rules are either not existing or are considerably weaker than in the UK. Interviewee U6 argued that this issue is particularly relevant for globally trading (re)insurers.

However, Interviewee U6's concerns were not limited to client money, but also to behavioural issues. For example, a broker could pretend to work on behalf of the client without actually having a mandate or a license. In addition, an intermediary might not sufficiently monitor whether its client is not involved in criminal or fraudulent activities. In 2009, the UK subsidiary of AON Corporation, AON Limited, was fined by the FSA (the predecessor of the FCA) £5.25 million for failing to have a risk management system in place relating to suspicious payments to overseas third parties in order to win new business (FSA, 2009). Questioned why these behaviours could impair the reputation of an insurer, interviewee U6 thought that stakeholders (e.g. policyholders or shareholders) will ask questions why the insurer is either dealing with a fraudulent organisation or why it failed to monitor the risks.

Changing dynamics of underwriting process

The changing dynamics in the underwriting process were highlighted by Interviewee U5 who emphasised that brokers typically expect quick decisions from underwriters. However, with the introduction of pricing and catastrophe models this has changed and there is more reliance on these models. Especially for complex risks, brokers are normally asked to come back whilst actuaries and underwriters run the risks through their models in order to determine a risk-adequate price. Brokers sometimes see this as a hindrance or a slowing down of the underwriting process and regret the loss of 'entrepreneurial spirit'. This also means that potentially the relationship between the broker and underwriter becomes less important as underwriting is more guided by the outcome of models.

Contract certainty has helped to reduce claims disputes – that does not mean that reputation and/or trust become obsolete?

Interviewee U7 highlighted that in the London Market claims disputes are a pertinent issue; however, this has been alleviated by the introduction of contract certainty. According to U7 contract certainty has brought more clarity between the parties and hence there is less scope for disagreements. However, it was also pointed out that in a soft market underwriters are keen to get business; thus might be either be more lenient when it comes to claims payments or are just betting that claims would emerge during a hard market period where underwriters have a stronger position. There is an expectation that in a hard market brokers would find it difficult to move business; hence insurers could find it easier to dispute claims.

Before the introduction of the contract certainty cover notes or slips very often stated 'To be agreed' or 'to be determined'. These unclear terms and conditions have often led to claims disputes; frequently ending up in court. Both parties (underwriters and broker) will argue about the intention of the cover note and courts will then have to decide who is right or wrong when no explicit clause has been agreed upon. However, it should be pointed out that reputation and trust will still play a role as uncertainty about the behaviour of underwriters when a claim occurs still exists, despite improved contract certainty.

Are personal relationships and entertainment more important than reputation and trust?

Questioned what role entertainment plays in the London Market Interviewee B4 highlighted that this has become less important and it has less influence than it used to be. However, there is still a social influence in the sense that it becomes more a sign of friendship in a close-knit community. If someone (a broker or an underwriter) is prepared to spend more time with the other person than it goes beyond professional relationships. What is important here is that this also changes the dynamics in the professional relationship:

'Once you move into friendship you naturally would like to do a better job as opposed to someone who just sits down and who is always rude to me. The sooner I can get him out of my head the better. And you can see why one would favour one over the other.'

Questioned who would be the beneficiary of this relationship, Interviewee B4 highlighted that it could be both parties:

‘The underwriter may be more tolerant to a broker who has become his close friend. The broker may be able to get better deals out of an underwriter. The underwriter may see a better spread of business. So it can be a symbiotic relationship.’

Questioned whether this friendship could cause problems during business negotiations, Interviewee B4 responded this would really depend on the dynamics of that relationship. For example, there might be brokers who behave sycophantically which helps them to place difficult business with underwriters. However, this may also lead to underwriters taking advantage of this behaviour thus abusing this relationship. Conversely, underwriters may show the same traits and thus being abused by brokers. In conclusion, Interviewee 4 pointed out that ‘so even within an underwriter’s portfolio of brokers you find a range of personalities’. In response to the researchers remark that this ‘sounds like a marriage’, Interviewee B4 agreed by concluding:

‘That’s why I am saying even with the same features you find granularity and within that granularity you find further granularity.’

Does the move to electronic communication dilute the importance of reputation and trust?

Interviewee B1 was asked about the impact of the move to electronic trading in the London market. B1 argued that for complex risks electronic communication dilutes the value in the sense that e-mails or other electronic messages might be misconstrued and there is very often a need to further explain the information provided in writing. For sharing information electronic means are adequate, but for concluding transactions personal communication cannot be replaced. In the words of B1:

‘You will only know whether the person you are dealing with it is the right person unless you have seen the whites in his eyes.’

Reputation of underwriters and brokers enhances job prospects

Interviewee B1 also alluded to the small community of specialist underwriters which leads very often to a ‘merry go round’ (own comment) game whereby underwriters (and sometimes whole

teams) are poached by other insurers. Here it was emphasised that the reputation moves with the underwriter, i.e. it is not necessarily linked to the insurer the underwriter is working for.

It is quite common in the London Market that underwriters and brokers move around and change insurers on a regular basis. This is partially because they are looking for a new challenge, or because they are poached by other insurers who wish to enter new lines of business or want to grow in a specific market. A sample of job announcements in the Insurance Day during June/July 2013 in Table 21 illustrates this:

Table 21 Sample of job announcements June/July 2013 (Source: Insurance Day, 2013)

<p>Insurance Day 10th June 2013</p> <p>Lloyd's broker RFIB has added to its broking capabilities within the niche yacht sector after recruiting Ashley Judd to its team.</p> <p>Judd has more than five years' experience of serving on board yachts and the larger superyachts. He most recently served as chief officer and acting captain of a 54-metre-long schooner</p>
<p>Insurance Day 18th June 2013</p> <p>James Cunnington has left Kiln after 11 years to join Hardy as head of reinsurance. Having graduated from Oxford in 2001, Cunnington joined Kiln's graduate training scheme and has specialised in reinsurance since 2004. His most recent role was outwards reinsurance manager, where he was responsible for co-ordinating reinsurance arrangements for multiple syndicates across a broad spectrum of business classes.</p>
<p>Insurance Day 25th June 2013</p> <p>RSA has lured Chris Hart back from QBE, where he worked for two years building and leading the global network, to serve as RSA global network manager.</p> <p>The London-listed insurer has committed to building its network which already gives it the ability to write business in around 150 territories through partner insurers in the region.</p>
<p>Insurance Day 2nd July 2013</p> <p>Former executive director of claims at Willis, Jayne Goddard, has joined Barbican's e-risks team as a cyber underwriter, as the insurer ramps up its technology-related risk offerings.</p> <p>She has worked in the insurance sector for 30 years. As executive director of claims at Willis in London, where she was the senior claims professional within the professional risks team, she was the primary point of contact for all technology-related claims matters.</p>
<p>Insurance Day 10th July 2013</p>

Watkin's syndicate 457's long-serving energy underwriter and account manager James Flude has joined the UK arm of Lancashire Insurance Company to head its own energy and marine team.

Flude has spent the past 14 years with Watkins, but his time with the business has come to an end as he has taken up the newly created role of head of energy and marine in the UK – a position he will not take until the beginning of next year

7.5 The role of reputation and trust in lead and follow underwriter decisions

Underwriters consider reputation as a pertinent factor for insurers who are asked to follow an insurance programme. Underwriters would gain a reputation for being able to lead an insurance programme. Interviewee U7 sees a strong role for reputation in order for followers to decide whether to participate in a risk (to put a line down on a slip). As an additional point, the reputation of the broker who is offering an underwriting line to followers is also relevant. The capacity aspect from a broker's perspective was emphasised by Interviewee U7. Brokers would look at underwriters' reputation to have sufficient capacity to write a risk as a lead insurer because of the (unwritten) rule in the London Market that each follower should not write a larger line than the lead insurer hence the need to find an appropriate underwriter. The signal function for followers if the lead underwriter takes a larger share of a risk was also highlighted as this provides an indication that the lead insurer is content with writing a certain risk.

Brokers would have to evaluate the underwriting capabilities of underwriters (e.g. has the underwriter a proving track record to write certain risks) in the London market. However, even where a lead insurer has a reputation for strong underwriting capabilities, but has a reputation for unsatisfactory claims handling, brokers might decide to place the business with another insurer as claims handling is regarded as one of the decisive factors for a lead insurer.

Interviewee U1 pointed out that the claims handling capabilities of a lead insurer are a crucial factor for followers in some lines of business, in particular in property and business interruption. In this line of business if a lead insurer is unable to settle claims expediently and to help the insured to get back to business quickly, the payments for business interruption claims could increase quite significantly. This is because the longer an insured firm is unable to get back to

normal business and start generating revenue the higher the pay-out for loss of profits from the insurer.

Interviewee U7 pointed out that there are underwriters in the market who the interviewee would not accept as lead underwriter and this is where reputation comes into play. There is also a reputational risk if the lead insurer handles claims very badly as this would also badly reflect on the followers.

The majority of interviewees agreed that it is easier to place business if an underwriter has a strong reputation for being able to be a leader. However, Interviewee U5 caveated that these days all underwriters, including followers, have become more sophisticated which means that followers do not automatically accept what the lead insurer is proposing in terms of pricing. Most underwriters employ pricing models before making a final decision hence followers would not solely rely on the reputation of the lead insurer.

Questioned whether brokers care about the reputation of follow underwriters even if they only write a small line (e.g. 1%), Interviewee U7 confirmed that this was the case. Firstly, this is because brokers are keen to have a contingency or backup in case other follow underwriters plan to discontinue their lines (at renewal). If other followers (who are staying on) have the capacity to write a larger line than it is easier for the broker to finalise the renewal as existing underwriters know the risk and are therefore more willing to write a larger line. There is also a competition aspect insofar as insurers who are already on the slip are unlikely to compete for this business through a different broker and try to undercut the price and move the business.

Interviewee B1 pointed out that the London market is a subscription market hence follow insurers would typically accept what the lead underwriter has negotiated in terms of policy wording and pricing, but also in terms of claims settlements. Again the role of reputation and trust was emphasised for these transactions as followers commit their capacity for certain insurance programmes. There might be different pricing strategies amongst the potential lead underwriters, but in the end it is about the reputation a lead underwriter has in the eyes of the follow insurers which determine whether the market wants to follow the lead. If an insurer is an acknowledged lead underwriter, pricing is less of an issue even if the followers pricing models would indicate that different rates should have been charged. Followers recognise that different business models (such as a smaller branch network) may result in a lower cost base hence lower premium rates. However, interviewee B1 was clear that the relationship impact is much stronger: *'In the end it does boil down to people'*.

Interviewee B1 also highlighted that lead underwriters are not necessarily interested in who the followers are. This statement is slightly contradictory to that of Interviewee U1 as lead insurers will have to rely on the ability to share the burden of claims payments (as a proportion of the signed line) at a later stage.

7.6 The role of reputation in the insurance purchasing process

The objective of this section is to discuss how reputation and trust influences the way corporate clients buy insurance in the London Market through brokers. Although, only one interview was conducted to explore this issue, the interview with a representative of AIRMIC provides a flavour about the factors influencing the choice of underwriters and brokers for insuring and placing the buyers' risks. The interviews with brokers were also used to ask their views about how corporate clients choose underwriters and brokers, and what role reputation and trust plays in the decision process.

The view from an insurance buyer's perspective

A representative of AIRMIC, the association of insurance buyers and risk managers within corporations, was interviewed about the role of reputation in the insurance buying process. Although no interviews with corporate insurance buyers were conducted, it can be assumed that AIRMIC's view reflects the experience/opinion of many AIRMIC members and insurance buyers in the UK.

AIRMIC distinguishes three main different types of insurance buyers:

- **People who work in procurement** tend to be totally price driven, i.e. the decision criterion is the cheapest offer.
- **Relationship driven buyers** who appreciate long-term relationships with insurers and brokers, and who regard insurers and brokers more of partners rather than the either the cheapest insurance provider or the broker who can negotiate the lowest price.
- **A mix of both:** insurance buyers may be price conscious, but also appreciate a longer-term relationship with an insurer and broker. These buyers would put the existing insurance programme out to tender in regular intervals in order to test the market.

For the two latter types the reputation of the insurer plays an important role, but the more crucial factor is the reputation of the broker. This has to do with the intermediary function

insurance brokers have. Brokers typically negotiate the terms and conditions with the underwriters and would search for a suitable insurer. Especially for globally active industry clients, the capability of insurers to handle larger insurance programmes and the availability of a world-wide branch network are paramount. For that the broker's knowledge of the insurance market is crucial and this will drive the reputation of brokers amongst insurance buyers.

AIRMIC pointed out that brokers are there to test the markets and they should also understand the markets. This would also include the reputation of insurers in the markets where corporates buy insurance. In addition, brokers should understand what terms and conditions insurers normally apply for certain insurance policies as well as current pricing levels for the relevant classes of business.

Notwithstanding this, corporate buyers will have an idea about the reputation of the insurer and they would make their preference clear. The interviewee mentioned a niche insurer who specialises in insuring larger risk and who has a reputation for good risk management and a particular reputation for understanding engineering risks. Corporate clients who are looking for engineering insurance would therefore see this particular organisation as a preferred insurer regardless of what the broker may recommend.

One of the critical areas which drive the reputation of insurers is how they handle claims; a factor which is also acknowledged by underwriters and brokers alike. This issue is even more pertinent in liability insurance where claims can emerge after a long period. Each claim would have to be paid by the insurer whose policy was in place when, for example, an insured was exposed to something (occurrence) which later causes health problems (claim). Occurrence made policy means that the insurer whose policy was in place when an incidence occurred is responsible to pay the claim and not the insurer whose policy was in place when an actual claim emerged. For example a worker might have been exposed to asbestos, but health problems which give rise to a claim might emerge years later (Thoyts, 2010). The insurance buyer is therefore reliant on broker's advice that the insurer is financially sound and is capable of handling either a larger number of claims or more complex claims.

AIRMIC highlighted that insurance buyers might be reluctant to move to another insurer even if there are concerns about the financial strength (such in the case of AIG) or the claims handling capabilities of an insurer. Especially where corporate buyers have liability insurance in place with outstanding liability claims there is a concern that if this insurance is switched to another insurer, the existing insurer might start slowing down the claims handling process in the knowledge of

the cancellation of a liability policy. It was also emphasised that reputation of an insurer in respect of claims handling does not only hinge on the question of the willingness to pay, but also on competence to understand the nature of claim and how to deal with it.

The brokers' perspective on the factors influencing the choice of insurer by their clients

Interviewee B1 and B5 concurred with AIRMIC's statement that the reputation of the broker is more relevant than that of the insurer. It was stressed that the competence of the broker is a driving factor of reputation and brokers, who have the specialist knowledge of certain industries required to assess risks, can gain a competitive advantage as they are able to 'sit in front of the clients and know what they are talking about'.

There is an expectation that the broker will advise on the most appropriate insurer through the due diligence process. However, interviewee B1 pointed out that brokers will try to get underwriters and clients together, so that both sides understand what is expected from each other. In addition, this provides both parties with the opportunity to judge for themselves who they are dealing with. For example, underwriters will be able to form a view how adequate a client's risk management system is. Clients, on the other hand, can assess whether the underwriter understands the industry the client is in and is able to assess the risks appropriately. The reputation of the broker both vis-à-vis the underwriter and the client could be influenced by the ability to bring the right people together, i.e. competent underwriters, who can also communicate with the client, and vice versa clients who are competent to describe the risks and their risk management system which enables the underwriter to form a positive view of the risk to be insured. The implication is that clients will not only evaluate a broker's ability to place the business at best possible terms, but also a broker's ability to choose the right underwriter. Conversely, underwriters would potentially reevaluate the risk in light of a client's statement regarding, for example, risk management practices which might be different from that of the broker. As such, the reputational relationships are not only formed between the client and broker, but also between the underwriter and the client which may lead to a different risk assessment by the underwriter.

Interviewee B1 added that clients will have a certain reputation for how they do things. Risk management is a critical factor as this provides an indication for the susceptibility to have claims. Reputation is formed through previous experience (e.g. accident record or theft of machinery record), but also through what clients make out to do and then later fail to do. This in turn can

create trust and mistrust. For example, if clients agree to ensure that all workers wear hard hats and they do not enforce this rule which in turn results in a higher number of accidents this will influence the judgement of brokers. These insurance buyers will thus have a bad reputation for risk management which in turn could make it more difficult for a broker to place the risk.

Interviewee B1 also claims that brokers will have a good idea who is the 'Rolls Royce' in certain industries which is part of their intermediary role to be able to differentiate between high risk and low risk clients. The interviewee also stressed that insurance buyers mainly consider the reputation of the individual broker, although some clients are more concerned with overall reputation of the broker firm irrespective of the individual broker.

Interviewee B5 confirmed that experience of the broker as a relevant decision for clients. For existing business, the relationship between the client and the broker is important factor and the reputation of the broker can determine whether a client is willing to retain the business with the current broker or move it to a new broker. There is a strong competition between the brokers in the London insurance market and brokers have to work very hard to either gain or retain business, but a good reputation can alleviate this to some extent. However, the interviewee emphasised that in some markets clients are taking advantage of this strong competition, such as in Latin America, where clients are actually trying play out brokers against each other. Ultimately, this can damage the reputation of the broker in the eyes of underwriters as someone who is only interested in reducing prices and not in the expertise. Conversely, the reputation of clients can also be damaged in the eyes of brokers and some brokers may not be willing to play this price cutting game because of the potential implications when dealing with underwriters.

Interviewees B2 emphasised that they would certainly make clear to the clients the positives and negatives of the individual underwriter, not just the company he works for. They also pointed out that most of their clients come and meet the underwriters, so they can form their own opinion of the underwriters who provided a quote. It also enables the client the find out whether these underwriters are able to write the clients' programmes.

Interviewee B3 pointed out that price is always an important factor for the client. However, where insurance buying is the responsibility of a procurement department the price is paramount as these departments are incentivised to save money and are therefore not interested in quality. Interviewee B3 used the example of procurement department which the interviewee saw as being run by a 'human robot' and who was younger than 30 years and who

reminded the interviewee of the character “Dalek” ¹⁰in the Dr Who TV series (BBC, 2014). This company had a complex global insurance programme in place covering a larger number of countries with very wide insurance cover and high limits. Interview B3 concluded that

‘this programme was tossed around [in the London market] as if it was some shed.’

Interviewee B4 emphasised that it is the broker’s responsibility to advise a client on the potential pitfalls of choosing a cheaper insurer:

‘It will become part of the dialogue between the broker and the client. Do you really want them as the leader? Do you really want them on your programme? Or if you going to have them on the programme let’s have them on the higher layers not on the lower ones where there is lot more claims activity, lot more interpretation.

[..] You know this is a market which is extremely granular. And it is granular in almost six, seven or nine dimensions in terms of people, class relationships, broking house, broking house style, company house, company house style. To generalise is great, but all generalisations cut through a huge range of granularity around the generalisation.’

Interviewee B4 added an experience with a (re)insurer,

‘who got a very bad reputation for challenging claims of casualty nature in the market. This became part of the dialogue between the broker and the client. “Look be careful if you are unprofitable and they don’t write that business anymore you will be having a nightmare. Every claim will be picked over just be aware that’s a danger.” But what the client does about it; that’s his decision. ‘

Interviewee B4 responded about the question how clients choose brokers in light of strong competition in the London market as follows:

‘It entirely depends on the class of business, the type of client, the type of relationship he has in the market. What he has to have and what you would like to have. I don’t think there are any hard and fast rules.

For example, one can start to differentiate between difficult business, between long tail and short tail, between retail and reinsurance. Business where the relationship between the buyer and

¹⁰ From the BBC website: ‘Genetic mutations housed in armoured travel machines, the Daleks are the distillation of all that is evil in the Universe.’

seller is a simple relationship i.e. I am the buyer and I buy one type of insurance from the seller. This is opposed to having multiple relationships with potentially a seller with a range of relationships across a number of classes of business. So, each would have their own dynamics. So, in another of those circumstances you would take a different attitude to your short-tail business if at the same time you want to get a good deal for your complicated long-tail business. There might be a trade-off, too.

So, from a buyer's perspective, I might not be too harsh on your short-tail pricing as long as I am satisfied you are giving me a long-term relationship on my long-tail business. You can see from this example alone it already creates a lot of dimensions.'

Questioned whether buyers actually differentiate between the various classes of business, Interviewee B4 responded:

'Some do. Some don't. I think it is determined by the class by the depth and breadth of the relationship. All of that counts.'

The choice of brokers by the client

'70% of business is lost through bad service and 70% is won through price' (B3)

Interviewee B3 wanted to point out that there is never a single reason for a client to switch to another broker and Interviewees B2 argued that the choice of broker really depends on the client. For example, larger multinational clients would probably choose the larger broker houses because they require a global network which only the larger brokers can provide. For these clients

'going into bed with a broker who is based in East London' (B2)

would not make sense whereas a local broker can provide the full range of services for local business.

Asked about how brokers differentiate themselves from each other, Interviewees B2 acknowledged that this is a very big challenge. However, the aim is to outperform others by providing better service or being more responsive in day-to-day dealings, such as claims handling. It is possible to secure business by providing better service, such as claims handling or risk management, thus creating a competitive advantage.

Interviewee B3 pointed out that there are a number of triggers which can lead to a change in broker. Examples include mergers and acquisitions, changes in staff [who buy insurance] or a failure in providing the required service. However, when a client changes the broker Interviewee B3 thought this can essentially be blamed on a relationship breakdown between the broker and the client, although it is not clear whether this is triggered by the broker or client. In terms of how brokers are trying to gain new clients, Interviewee B3 used the phrase:

'We have people dedicated to romancing'

to explain the acquisition process. In addition, if a client is considering moving to another broker, the client would invite a number of brokers to do a presentation, which can look like a 'fashion show catwalk'.

The influence of the brokers' recommendation on clients' choice of underwriters

Asked about how a broker's recommendation influences a client's choice of underwriter Interviewees B2 acknowledged that this really depends on the client. They believe that the larger clients are much *'more clued up and they have a good idea what they want.'*

This means that if risk managers are involved in the insurance purchasing process they would be more immersed in the process hence they would have a good idea what they require and they want. Other senior management people who are not as immersed as risk managers would much more rely on the recommendation of the broker.

Interviewees B2 also provided an example of a specific line of business, namely political risk, where they are working together with their risk consultants to advise the client:

'Because we deal with emerging markets we try to make the client aware of risks and one of the important decisions might be to transfer the risk to an insurer. But they [the client] might also say, you know what, we are big enough we can retain it. In the London market we are dealing with worldwide risks and we can advise the client, for example, in Asia to transfer risks to America.'

Interviewees B2 concluded that as long they have advised the client on the options available, they have fulfilled their duty as brokers and it is up to the client to decide which option to go for.

Interviewees B2 provided a further example in energy insurance, as to how brokers advise clients on the options available and what decisions clients might make, in particular striking a balance between price, financial strength and claims service:

'In energy, most of our clients are very knowledgeable, so it is incumbent on us to put the options for the client on the table. For example, one client might want to go for a cheaper option with a more complicated structure which has lower rated insurers on the slip and others prefer higher rated insurers who are slightly more expensive. As long as we put the options on the table that's fine.'

It is really up to the client as long as we advise the client and point out the pros and cons. So for example, the more complex programme may face difficulties when it comes to a bigger claim whereas the straightforward programme with higher rated insurers might settle claims much quicker.

I think at the moment price is the crucial factor for the client. In the economic downturn, risk managers are normally told to come up with savings. Also, clients are happy with lower prices as long as the cover stays within a certain limit or conversely they might ask us what they can get for a certain budget.'

7.7 Conclusions

An extended decision map was introduced in Chapter 5 which incorporated the findings from existing research into the workings of the London insurance market. The interviews with underwriters and brokers, but also with a representative of insurance buyers provide further insight into the role of reputation and trust in the London insurance market. These additional findings are highlighted in the updated decision map (Figure 30). The red buttons shown in the decision map are further explained in Table 22 and highlight the additional findings from the interviews with underwriters and brokers.

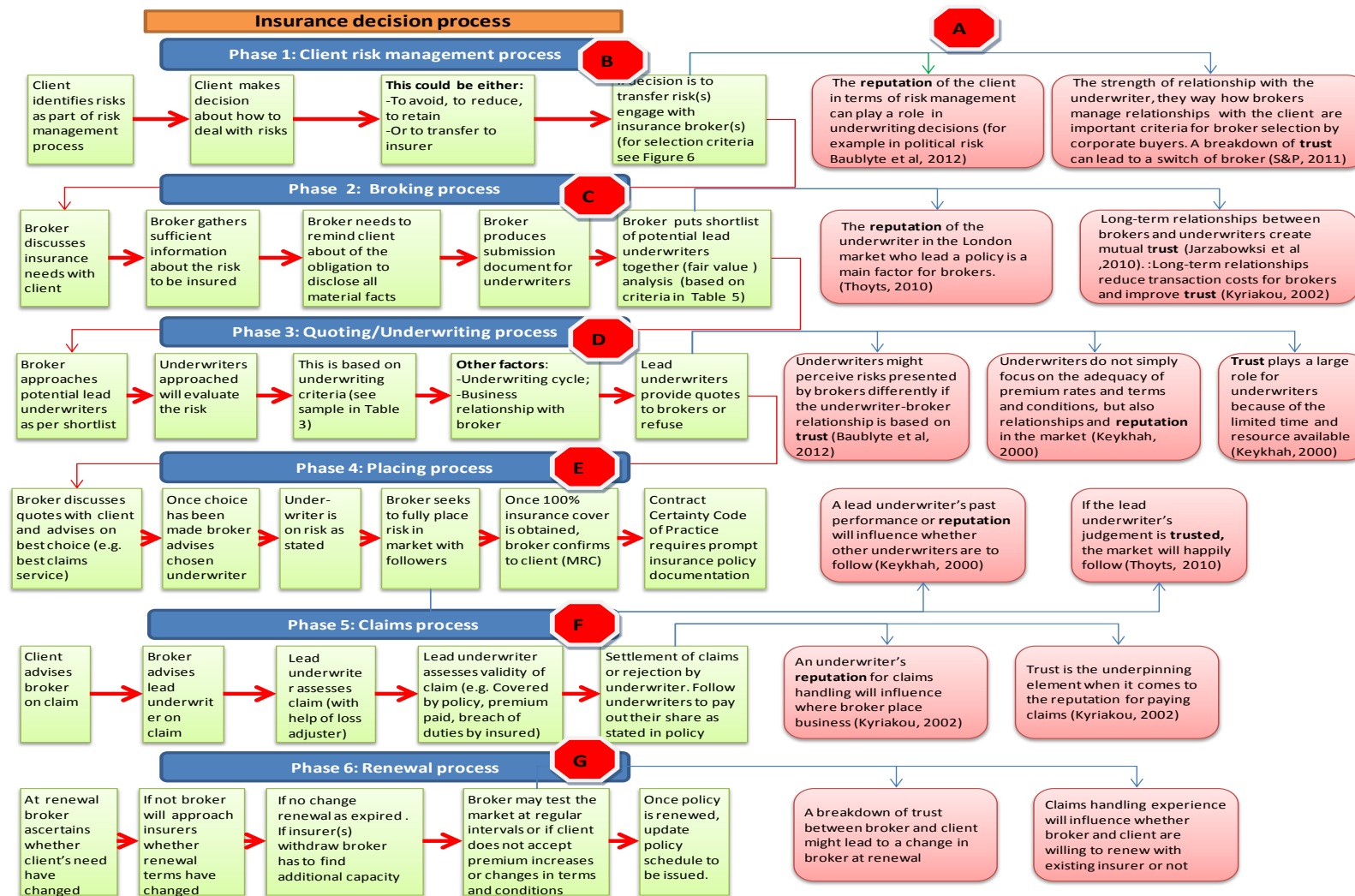





Figure 30 Updated decision map (own diagram)

Table 22 Notes to updated decision map

Decision phase	Evidence
 <p>General functioning of reputation and trust:</p> <p>No uniform definition provided by underwriters and brokers, but role of reputation and trust in the London market is generally acknowledged</p>	<p>‘Reputation means that individuals or firms are trusted. This can be positive in the sense of providing complete information. It also involves a straightness of information or good claims service.’ ‘Reputation can be driven by an individual’s behaviour. If someone is a bit sharp or close to wind this can influence the broker/ underwriter relationship.’ (U5)</p> <p>‘Reputation is a validation process, it is based on experience. It is something which is established over time. It is a validation process of integrity and honesty which is also based on the skills to present things in an honest way.’ (B1)</p>
 <p>Phase 1: Client risk management⁰ process</p> <p>Corporate buyers appreciate long-term relationships with a reputable insurer, but this also depends on who makes the decision within the corporation</p>	<p>Especially for globally active industry clients, the capability to handle larger insurance programmes and the availability of a world-wide branch network are paramount. For that the broker’s knowledge of the market is crucial and this will drive the reputation amongst insurance buyers.</p> <p>And the other extreme:</p> <p>Interviewee B3 used the example of procurement department which the interviewee saw as being run by a ‘human robot’ and who was younger than 30 years and who reminded the interviewee of the character “Dalek” ¹¹in the Dr Who TV series (BBC, 2014). This company had a complex global insurance programme in place covering a larger number of countries with very wide insurance cover and high limits. Interview B3 concluded that</p> <p><i>‘this programme was tossed around [in the London market] as if it was some shed’</i></p>
 <p>Phase 2: Broker Process</p> <p>Reputation can be decisive when it comes to a broker’s decision to award business as reputation creates trust that underwriters are</p>	<p><i>‘[...] business is based on trust; the business is about integrity which contributes to reputation. If you overstep the mark this damages the reputation and hence the trust [...] because relationships underpin the business. [...] There is a huge amount of information being shared between underwriters and brokers which is critical for risk assessment. The information can be presented in different ways because they are human beings. There is pressure to make money and there is pressure to close a deal, so reputation and trust are important in these transactions’.</i></p>

¹¹ From the BBC website: ‘Genetic mutations housed in armoured travel machines, the Daleks are the distillation of all that is evil in the Universe.’

Decision phase	Evidence
<p>competent, behave with integrity and do not renege on what was verbally agreed.</p> <p>Reputation works as sanction mechanism as underwriters with a negative reputation will be punished by brokers</p> <p>A good reputation can also provide a competitive advantage as price becomes less important.</p>	<p>The reputation of the underwriter will affect the amount and the quality of business they get. If you have an underwriter “who is a pain in the arse”, he or she is unlikely to show better business.’</p> <p><i>‘Reputation can be decisive when brokers make decisions about who to award business. There were cases where insurer [...] gained business despite being more expensive.’ (U6)</i></p>
<div data-bbox="219 679 320 767" data-label="Image"></div> <p>Phase 3: Quoting/underwriting process</p> <p>The reputation of the broker plays a role for underwriters when it comes to underwriting decisions.</p> <p>Reputation works as sanction mechanism as underwriters may refuse to work with brokers who are dishonest</p> <p>Through a good reputation underwriters may trust brokers more thus reducing the decision time (for example by relying more on the verbal presentation of the broker rather than the written submission.</p>	<p>Interviewee B4 also emphasised the sanction mechanism of reputation by pointing out that brokers who attempt to lie to underwriters will one day be caught out and from that moment the broker will be a ‘marked man’ and underwriters’ trust would have diminished which in turn would limit the ability of a broker to do deals with an underwriter. This can be crucial when a broker is under pressure to place insurance cover at the last minute (for example, late Friday afternoon). So a broker might approach an underwriter in the London market asking for immediate cover with the plea:</p> <p><i>‘Look I am fairly certain about the security. I know the client I haven’t got all of the information, but it’s gonna be done tonight.’</i></p> <p>If the broker has a good reputation then it would be easier for an underwriter to provide insurance cover because he can trust the broker. However, if the broker has a reputation for ‘always telling a pack of lies’ the underwriter might turn to the broker: <i>‘I need all of that in writing and I need it signed off before I can even think about.’</i></p> <p>U2 was asked whether there were cases where reputation and trust impacted the decision regarding the assessment of risks, U2 replied that there was an incidence where a broker had produced a very lengthy submission and U2 didn’t want to go through the entire submission. Consequently, the interviewee asked the broker to explain the salient points, but this would not have happened with a broker U2 could not trust.</p>
<div data-bbox="219 1222 320 1310" data-label="Image"></div> <p>Phase 4: Placing process</p> <p>It is easier for brokers to place business with followers if the lead underwriter has a good reputation to lead an insurance programme. The size of the line the lead underwriter takes also indicates that</p>	<p>Interviewee U7 sees a strong role for reputation in order for followers to decide whether to participate in a risk (to put a line down on a slip). As an additional point, the reputation of the broker who is offering an underwriting line to followers is also relevant. The capacity aspect from a broker’s perspective was emphasised by Interviewee U7. Brokers would look at underwriters’ reputation to have sufficient capacity to write a risk as a lead insurer because of the (unwritten) rule in the London Market that each follower should not write a larger line than the lead insurer hence the</p>

Decision phase	Evidence
<p>he/she are happy to take the risk, so reputation provides a signal function.</p>	<p>need to find an appropriate underwriter. The signal function for followers if the lead underwriter takes a larger share of a risk was also highlighted as this provides an indication that the lead insurer is content with writing a certain risk.</p>
<div data-bbox="203 507 304 600" data-label="Image"> </div> <p>Phase 5: Claims process</p> <p>The reputation for claims handling can have a significant impact on whether brokers and clients trust an underwriter. It is the ultimate signalling and sanction function of reputation</p> <p>Follow underwriters will also look at the reputation of the lead underwriters for speedy claims handling</p>	<p><i>'Reputation is influenced by how you handle claims, how employees behave or interact with others. Brokers would move business when an insurer has a bad reputation for bad claims handling.'</i> (U2)</p> <p><i>'Reputation can be (negatively) impacted when an insurer does not respond adequately, where there is no serious underwriting or when claims handling is unsatisfying. In addition, behaving in the market aggressively is a factor.'</i> (U4)</p> <p>Interviewee U1 pointed out that the claims handling capabilities of a lead insurer are a crucial factor for followers in some lines of business, in particular in property and business interruption. In this line of business if a lead insurer is unable to settle claims expediently and to help the insured to get back to business quickly, the payments for business interruption claims could increase quite significantly. This is because the longer an insured firm is unable to get back to normal business and start generating revenue the higher the pay-out for loss of profits from the insurer.</p> <p>Interviewee U7 pointed out that there are underwriters in the market who the interviewee would not accept as lead underwriter and this is where reputation comes into play. There is also a reputational risk if the lead insurer handles claims very badly as this would also badly reflect on the followers.</p>

Decision phase	Evidence
<div data-bbox="219 389 315 475" data-label="Image"> </div> <p>Phase 6: Renewal process</p> <p>The way how underwriters deal with claims will influence whether the broker and the corporate stay with the same insurer. Insofar reputation works as a sanction mechanism as underwriters will lose business if they have a bad reputation for claims.</p> <p>Brokers may also be wary of underwriters who try to undercut prices as this might signal that these underwriters may try to save money when it comes to claims (reputation as signal function).</p> <p>Brokers also need to manage the relationship between the underwriter on one hand, and between the client and broker on the other hand. If a broker gets a reputation for being too aggressive he/she may find it difficult to either place business or keep the business with a client.</p>	<p>Interviewee B1 also pointed out that experience of underwriters would be revealed through pricing as underwriters who do not understand the risk presented either overcharge or undercharge. Subsequently, this can lead to consequences in terms of claims handling as underwriters who have undercharged for the risk may refuse claims or argue with the broker that they did not (fully) understand the risk or that they did not (fully) informed about potential problems. This behaviour can also create good or bad reputation.</p> <p>Interviewee B4 added an experience with a (re)insurer,</p> <p><i>‘who got a very bad reputation for challenging claims of casualty nature in the market. This became part of the dialogue between the broker and the client. “Look be careful if you are unprofitable and they don’t write that business anymore you will be having a nightmare. Every claim will be picked over just be aware that’s a danger.” But what the client does about it; that’s his decision. ‘</i></p> <p><i>The fact there is an annual renewal, the broker serves a slightly different role. That is if two people have a close personal relationship. The broker’s role is to manage this relationship. So the broker’s role is to facilitate that relationship between the client and the underwriter and find a price level where both parties can live with [...] and nobody feels unhappy about it. So there is all sort of interplay and relationships and trust. That is sort of classic shuttle diplomacy to intermediate as supposed to someone who is a champion on a big white horse who is going into battle and carve up the enemy for the sake of his client which is a very aggressive style without any fear of the consequences to what happens there after. Those are two extremes.’</i></p>

8 Discussion of web-based survey results

8.1 Introduction

The objective of the online survey was to test whether the responses of the interviewees, which were discussed in the previous chapter, are shared by a larger number of underwriters in the London insurance market. In particular, a general definition of reputation and trust together with how underwriters view the correlation between these two concepts were put to the underwriters. In addition, the survey aimed to probe whether underwriters accept the signalling and sanctioning function of reputation.

The survey was only conducted amongst underwriters in the London insurance market. Insofar, the discussion of the survey results relate only to the underwriting decision part of the main objective of this thesis, namely to explore what role reputation and trust plays in the underwriting and broking process, with a particular focus on the London insurance market. Parts of Section II and III of this chapter cover the sub-objective 'Consequences for business relationships between underwriters and brokers as result of a negative reputation', as stated in the abstract. Parts of Section II and III also relate to sub-objective 7: To investigate whether there is evidence that reputation and/or trust could be utilised to reduce the complexity of underwriting decisions.

Only 6 underwriters participated in the survey (although there were 7 participants up to question 3 in Section II). 2/3rds were male and 1/3rd were female. All participants are under 40 years old and each had less than 10 years' experience as underwriter. The class of business was evenly split between property and liability.

Clearly, with such a low number of respondents, it is impossible to test whether the findings of the interviews are shared by the wider underwriting community in the London insurance market, let alone draw general conclusions from the responses. However, it was felt that because of the efforts made to design the questionnaire, to move the questionnaire to the i-soton platform, to get approval from the ethics committee, and to find survey participants, it would still be useful to discuss the responses to this web-based survey. Especially, the answers to the open questions enrich the findings from the interviews.

The questionnaire was divided into three main sections: General questions, specific questions regarding the broker/underwriter relationship and specific questions regarding underwriter/broker/follower relationship.

8.2 Discussion of Section I responses:

This section dealt with general questions regarding the definition of reputation and trust as well as the importance of these two concepts for underwriting decisions. The responses are set out in Table 23. As regards the first question about the definition of reputation, an overwhelming majority saw reputation as perception related rather than judgment related. This contrasts with the variety of answers provided by underwriters and brokers during the interviews conducted. On the issue of trust, the outcome was less clear; however, the majority of respondents saw trust as an emotional issue and is acknowledged as important for business relationships in the London Market.

As regards the connection between reputation and trust, 71% agreed that trust and reputation are correlated as a positive reputation enables an individual to trust another individual or organisation. An interesting open answer from one respondent differentiated between reputation as perception and trust as more about reality. In addition, this respondent acknowledged that both are correlated in both directions either positively or negatively.

In respect of what role reputation plays in underwriting decisions, a majority thought that reputation plays a strong role; however, 29% indicated that reputation becomes only relevant when it comes to claims payments. In addition, one respondent made clear, in an open answer, that reputation is only one factor amongst others and to rely solely on reputation would not be a good underwriting practice. Concerning the role of trust, this concept is seen by the majority as important; however, 29% thought, similar to reputation, trust only becomes important when it comes to claims handling.

The final question of this section dealt with the interaction between reputation and underwriting. The answers are somewhat contradictory to the responses to the earlier questions. Whilst a majority acknowledged that reputation is an important factor in general (question 4), in a more specific question 43% of the respondents thought that the reputation of the broker or the broker house is not important. It is rather the price and the nature of the risk

which are more relevant. One respondent pointed out, in an open answer, that reputation of the client is more important than that of the broker or broker house.

Table 23 Responses to Section I questions

Section I : General questions	
Questions and answers	Responses
1. Which statement about reputation do you agree most with?	
a) Reputation is about how an individual or an organisation is perceived	89%
b) Reputation is about judging previous actions and draw conclusions for future actions	11%
c) Reputation is about the image of an individual or an organisation	0%
d) Reputation is whether I trust an individual or an organisation	0%
2. Which statement about trust do you agree most with?	
a) Trust is an emotional issue ; it has nothing to do with business relationships	14%
b) Trust is essential for business relationships; without trust underwriting in the London market would be difficult	29%
c) Trust helps to reduce the complexity of underwriting decisions	0%
d) Trust is an emotional issue, but is important for business relationships as it provides an indication whether the person(s) I am dealing with is (are) reliable	43%
e) Trust is an emotional issue but is important for business relationships as it reduces the complexity of underwriting decisions	14%
3. What is your opinion of the connection between reputation and trust?	
a) Trust and reputation are unrelated; they are formed independently	14%
b) Trust and reputation are correlated; through a positive reputation it is easier to trust an individual or an organisation	71%
c) When I trust someone and he/she keeps a promise this will create a positive reputation	0%
Open answer: For me reputation is more about perception. Trust is more about reality. The two are correlated in both directions both positively and negatively.	14%
4. What role does reputation play in underwriting decisions?	
a) The London market is relationship based so reputation of all market participants (e.g. Brokers, clients, lead or follower insurer) plays a strong role when making underwriting decisions	29%
b) The reputation of the broker is an important factor when making underwriting decisions	29%
c) Reputation is not important	0%
d) Reputation only becomes only important when a claim has to be paid	29%
Open answer: Relationships are important to the London Market but only one factor out of so many others. To rely solely on relationships and reputation would be unwise underwriting.	14%
5. What role does trust play in underwriting decisions?	
a) Trust is as important as reputation in the London market	29%
b) I need to be able to trust a broker before I do business with him/her	43%
c) Trust becomes only important when a claim has to be paid	29%
d) Trust is not important;	0%
6. How does underwriting and reputation interact?	
a) The reputation of the individual broker strongly influences what risks I accept	0%
c) The reputation of the individual broker somewhat influences what risks I accept; price is a more important drive.	33%
e) The reputation of the individual broker or broker house is not important; the price and the nature of the risk are the main factors	43%
Open answer: The reputation of the primary client is of more importance than the broker/broking house (although this is also a factor)	14%

8.3 Discussion of Section II responses

This section dealt with specific questions regarding the broker/underwriter relationship and the role price plays in negotiating business. The responses are set out in Table 24. The responses to the first question appear to be contradictory to the answers in Section I where reputation was regarded as important in the London Market. Questioned whether price or reputation is more important when a broker wants to place a risk for which he/she struggled to find capacity, 71% responded as long as the price is right, reputation is not relevant and only 29% responded that if the reputation of the broker is good then they would accept the risk, subject to an overall profitability of the broker's portfolio.

The second question tried to find out whether there is evidence of a heuristic behaviour of underwriters when there is a good reputation of a broker. A number of underwriters who were previously interviewed alluded to this behaviour. In the survey, 43% responded that they would still go through the entire documentation regardless of the broker's reputation, only 14% answered that they would not go through the whole document if the broker has a good reputation and 43% responded that the submission is important, but the individual risk appetite of the underwriter is even more important.

Question three dealt with the potential sanction mechanism of reputation. The majority (57%) thought that because of the strong competition in the London Market it would be impossible to cut ties with a broker who misbehaved, but they would be more sceptical the next time they deal with this particular broker. The question whether there is a difference in the role of reputation depending on the market cycle, 33% responded that in a soft market the broker is in strong position, so reputation is less important. However, one participant made clear that reputation is important across all cycles, but it is only one factor amongst many and one respondent pointed out that a broker's behaviour throughout the cycles makes or breaks reputation.

The next three questions dealt with variations in the importance of reputation depending on new versus renewal business, short-tail v long-tail business, and complex versus straightforward business. As regards new versus renewal business, the majority thought reputation is always relevant regardless of the nature of the business, whereas in respect of short-tail v long-tail business there was no clear view whether there is a difference. One respondent pointed out that some underwriters place an enormous importance on a broker's reputation and others

don't. Concerning a difference in the relevance of reputation by the complexity of the risks, 40% thought reputation is always a relevant factor whereas 17% responded that for less complex risk, the reputation of the broker is less crucial. Interestingly, 50% responded that if they have enough time to assess the risk, reputation would be less relevant as there is less reliance on the broker's presentation. This could indicate that if underwriters are under pressure, reputation and heuristics become more crucial.

The last question dealt with the market power of the three large broker houses, AON, Marsh, and Willis, and how this influences the role of reputation and trust. Here 67% responded that reputation and trust are important, but the market power of these brokers cannot be ignored whereas 17% said that irrespective of their market influence reputation and trust are always a relevant factor. 17% said the reputation and trust are not important because the main concern is either getting or retaining business.

Table 24 Responses to Section II questions

Section II : Specific questions - Broker/underwriter relationship	
Questions and Answers	Responses
1. A broker who you have been dealing with for a while wants to place a risk for which he/she struggled to find capacity. How would you decide?	
a) If the broker has a good reputation I would do him a favour and underwrite the risk	0%
b) If the broker has a negative reputation I would refuse to underwrite the risk	0%
c) If the price is right I would underwrite the risk regardless of the reputation of the broker	71%
d) If the broker has a good reputation I would write the risk but only if the entire broker portfolio is profitable	29%
e) If the broker has a bad reputation I would not write the risk even if the entire portfolio is profitable	0%
2. If one of the London Market broker's presents a new risk (e.g. a new construction risk in Abu Dhabi) how would you deal with the submission which is set out in a document of about 150 pages?	
a) If the broker has a good reputation I would trust his/her presentation without going through the whole document	14%
b) If the broker has a bad reputation I would go through the entire document and challenge the broker on the risk description in the submission	0%
c) Regardless of the reputation I would always go through the whole document before making a decision	43%
d) The submission is important, but in the end it depends on whether I think the risk is acceptable	43%
3. How would you react if you had accepted a risk because you trusted the broker but it later transpires that the broker misrepresented the risk?	
a) I would be furious and cut all ties with the broker	0%
b) I would talk to broker and try to understand why he/she behaved like that	29%
c) There is strong competition in the London market for business, so I would still have to deal with broker	0%
d) I would try to understand why the broker behaved like that but would still have to deal with him/her because of the competition in the London Market	14%
e) Because of the strong competition I would still have to deal with the broker but I would be more sceptical the next time the broker asks me to underwrite a risk	57%
4. Is there a difference in the role of broker reputation depending on the state of the market?	

Section II : Specific questions - Broker/underwriter relationship	
Questions and Answers	Responses
a) If there is plenty of capacity brokers will always be in a stronger position; so the broker's reputation is not important	33%
b) If there is a hard market the reputation of the broker plays a bigger role	17%
c) If there is a soft market, the reputation of the broker becomes more important as I don't want to write a risk which is under-priced and prone to claims	17%
d) If there is a hard market the reputation of the broker is not important as I can charge what I want	0%
Open answer 1: Reputation is important across all parts of the cycle as it's through the changes that a reputation is made	17%
Open answer 2: I've only experienced a soft market so can't really choose one of the above. Reputation is a factor but underwriters need to consider the information presented in the context of their portfolio and the market as well. Whether you trust the broker or not you still need to do a complete job.	17%
5. Is there a difference between new business and renewal business when considering the reputation of a broker?	
a) There is no difference between new and renewal business; reputation is not a consideration in either case	0%
b) There is no difference between new and renewal business; reputation is always a relevant consideration	50%
c) There is a difference between new and renewal business. For new business the reputation of the broker is more important. For renewal business I have more historical information, so reputation is less important	50%
d) For renewal business broker reputation is more important; for new business less so	0%
6. Is there a difference in the role of broker reputation by line of business?	
a) There is no difference in the London market. Reputation and trust related to brokers are equally important for all lines of business	33%
b) Broker reputation and trust play a much bigger role for long-tail business, such as liability	50%
c) For short-tail business, such as property, broker reputation and trust are more important than for long-tail business	0%
Open answer: Yes - by class placement type - but also underwriter. Some underwriters place an enormous amount of importance on broker reputation; others will consider the risk on its own. I think it's a factor amongst many other factors.	17%
7. Is there a difference in the role of broker reputation depending on the complexity of the underwriting proposal?	
a) There is no difference in the role of broker reputation regardless of the complexity of the proposal; reputation is always important	33%
b) For less complex risks broker reputation is less important, because the broker's presentation of the proposal is less crucial. However, for complex proposals reputation is absolutely essential	17%
c) If I am only asked to sign a small line as a follower I need to be able to trust the broker; hence reputation is more important regardless of the complexity of the proposal	0%
d) If I have sufficient information and time to assess the risk, broker reputation is not that important as there is less reliance on the broker's presentation	50%
e) For a lead underwriter broker reputation is always important. For a follower it depends on the size of the line	0%
f) For a lead underwriter broker reputation is only crucial for complex proposals. For a follower it depends on the size of the line	0%
8. Does the role of reputation and trust change if you are dealing with a larger broker (such as AON Marsh and Willis)?	
a) There is no difference. Irrespective of the size of the broker house the broker's house reputation and trust in the broker house are always important	17%
b) If I have to deal with three bigs (AON Marsh and Willis) reputation and trust are important, but I cannot ignore their market influence in price negotiations	67%

Section II : Specific questions - Broker/underwriter relationship	
Questions and Answers	Responses
c) Broker reputation and trust are not important at all; My main concern is either getting or retaining the business	17%

8.4 Discussion of Section III responses

This section dealt with potential views of brokers and follow insurers as perceived by underwriters. The responses are set out in Table 25. The first question concerned the main factors influencing an underwriter's reputation. These ranged from speed of claims settlement, underwriter expertise and capacity, and ability to price risk adequately. Speed of claims settlement was regarded as either very important or fairly important, but conversely expertise in claims handling was not seen as important by the majority (50%), but not necessarily as extremely or fairly important. However, underwriting expertise is thought be extremely important or fairly important and the behaviour of underwriters when dealing with a broker was also thought to be either extremely important or fairly important by all respondents. Unsurprisingly, the ability to price risks adequately was also regarded as high on the agenda.

Question two was an open answer question describing a situation whereby an underwriter would verbally agree a deal, but later renege. Here, most respondent agreed that this would be bad behaviour which in turn would influence a broker's view of an underwriter. However, on respondent also remarked that if there is lots of capacity in the market, brokers might be less concerned about this as business can be easily placed somewhere else.

The interaction of underwriting and claims service was probed in the next question. This was also an open answer question relating to the likely decision of a broker if an insurer had a bad reputation for bad claims service, but a good reputation for underwriting expertise. One respondent highlighted that there is not necessarily a connection between underwriting and claims services. Others thought that claims service does influence a broker's decision where to place business.

The fourth question provided a number statements regarding brokers' decision and respondent were asked to either fully, fairly or not to agree. This question aimed to double-check some of the answers provided in earlier parts of the survey. As regards the factor claims services versus underwriting capabilities the majority of respondents did not agree that claims services is more important than underwriting capabilities. The next statement regarding the factor price, the

responses were slightly contradictory as 60% fully agreed that price is always the decisive factor for brokers, but 60% also fairly agreed that price is an important factor, although other factors are more important. Interestingly, most respondents agreed that brokers appreciate a good relationship with underwriters and also appreciate insurers who stay in the business. Finally, 67% fully and 33% fairly agreed that brokers are more likely to place business with underwriters who know what they are doing.

The last question dealt with the lead underwriter/follow relationship and 83% agreed that the reputation of the lead underwriter is an important factor for follow underwriters when committing capacity. However, one respondent pointed out that followers will still review and model the risk regardless of the reputation of the lead underwriter.

Table 25 Responses to Section III questions

Section III : Specific questions - underwriter/broker/follower relationship	
Questions and Answers	Responses
1. In your view which are the main factors influencing underwriter reputation?	
a) Speed of claims settlement	
extremely important	33%
fairly important	33%
Important	17%
less important	17%
Not important at all	0%
b) Underwriting expertise	
extremely important	50%
fairly important	50%
Important	0%
less important	0%
Not important at all	0%
c) Underwriting capacity	
extremely important	33%
fairly important	33%
Important	17%
less important	17%
Not important at all	0%
d) Behaviour of underwriter when dealing with a broker	
extremely important	17%
fairly important	67%
Important	17%
less important	0%
Not important at all	0%
e) Expertise in claims handling	
extremely important	17%
fairly important	0%
Important	50%
less important	33%
Not important at all	0%
f) Ability of underwriter to form good relationship with brokers	

Section III : Specific questions - underwriter/broker/follower relationship	
Questions and Answers	Responses
extremely important	0%
fairly important	67%
Important	17%
less important	17%
Not important at all	0%
g) Ability to price risk adequately	
extremely important	50%
fairly important	33%
Important	17%
less important	0%
Not important at all	0%
2. If you had verbally agreed with a broker that you would underwrite a certain risk but you later renege on this promise. How do you think the broker would react?	
Very unhappy which I guess means reputation and trust do have a role	
Very poorly. Would not do this.	
frustration- it would be damaging to your relationship	
Depends on the broker and if the line could be replaced. Where there is a lot of capacity the broker would be less concerned. But some individuals can be very prickly regardless.	
Not well, they would rightly expect the risk to be written	
3. Your organisation has a good reputation for claims service but you have a negative reputation for underwriting expertise. How do you think this would influence a broker's decision to place new business?	
I'm not sure it would affect it at all - I don't believe the claims / placement parts of a broker are that well connected (necessarily so)	
Broker would not be keen as underwriting is on the front end and must always be gone through.	
have a big influence as they would be less willing to bring you business as you may not be at the company very long	
I think the broker would be less likely to place business with the company especially if the nature of the business means there is low probability of a claim	
You would only be considered for a following line	
4. Please indicate whether you fully/fairly. don't agree with the following statements regarding brokers' decisions:	
a) All things equal claims service is more important than underwriting capabilities	
fully agree	17%
fairly agree	33%
don't agree	50%
b) The price is always the decisive factor for brokers; all other factors are less important	
fully agree	60%
fairly agree	0%
don't agree	40%
c) Price is an important factor for brokers, but other factors are more important	
fully agree	0%
fairly agree	60%
don't agree	40%
d) Brokers appreciate a good relationship with an underwriter as this makes it easier for them to place difficult risks in the market	
fully agree	67%
fairly agree	33%
don't agree	0%
e) Brokers appreciate insurers who stay in the business even during difficult times and who do not move in out of the market depending on underwriting cycle	

Section III : Specific questions - underwriter/broker/follower relationship	
Questions and Answers	Responses
fully agree	83%
fairly agree	17%
don't agree	0%
<i>f) Brokers are more likely to place business with an underwriter who knows the industry (e.g. aviation) of the client</i>	
fully agree	67%
fairly agree	33%
don't agree	0%
5. How does the reputation of the lead underwriter influence the behaviour of the followers in the market?	
a) There is no influence; followers will only look at the price and the line offered by the broker	0%
b) Reputation of the lead underwriter is extremely important due to the subscription system in the London market	83%
c) There is a difference by lines of business; for long-tail business the reputation of the lead underwriter is more important	0%
d) There is a difference by lines of business; for short-tail business the reputation of the lead underwriter is more important	0%
Open answer: There will be a small amount of influence but it will still be reviewed and modelled regardless of the lead	17%

8.5 Conclusions

Given the limited responses to the web-based survey, it is not possible to draw wider conclusions from the answers of the underwriters to the questionnaire. However, when analysed in conjunction with the interviews discussed in Section 7, some trends can be observed:

- Reputation and trust are considered important features of the London insurance market. However, similar to the responses of the interviewees no clear picture is emerging to what extent these concepts influence underwriting decisions, especially in the context of price competition. Whilst 58% acknowledged that reputation plays an important or strong role in underwriting decisions, when combining this question with the correlation between pricing and reputation 86% thought that either the price is more important than reputation or the reputation of the broker is less important than price and the nature of risk.
- In terms of the definition of reputation, 89% saw reputation as something which is perceived, rather than a judgement of previous actions. This contrasts with the responses of the interviewees in which the judgemental nature of reputation featured more strongly and which may also have to do with confusion about the differences between perception and judgement. A positive correlation between reputation and

trust was confirmed by the majority of participants and mirrors the responses of the interviewees.

- Section II of the survey dealt with more specific questions regarding the broker/underwriter relationship. It is interesting to see that whilst there is a general recognition of the importance of reputation and trust, when it comes to relating this recognition to specific situations, such as analysing a broker submission or dealing with a broker who misrepresented this risk, the participants retracted to some extent from this general recognition. A point in case are the answers to question 6 (Is there a difference in the role of broker reputation by line of business?), where 50% thought reputation of the broker is relevant, especially for long-tail business, and 33% thought reputation is always relevant. However, in respect of question 1 (A broker who you have been dealing with for a while wants to place a risk for which he/she struggled to find capacity) 71% of participants answered that if the price is right they would underwrite the risk regardless of the reputation of the broker. This is in contrast to the responses of the interviewees where the majority of participants made clear that a good or bad reputation of a broker influences his/her ability to place business in the market.
- Section III contained a mixture of multiple choice and open questions regarding factors influencing reputation. Surprisingly, the survey participants saw claims handling (either speed or expertise) as important, but not as extremely or fairly important. This is in contrast to the emphasis the interviewees put on claims handling for retaining or gaining business. However, this may also have to do with underwriters just focusing on their own area (i.e. underwriting) rather than considering a more holistic picture. The importance of the reputation of lead underwriters for followers was confirmed by 83% of respondents. It is also interesting to see that a majority of underwriters believe that brokers appreciate either underwriters who do not behave opportunistically, or underwriters with industry expertise or a good relationship with the underwriter. This indicates that underwriters believe that soft factors, which influence reputation, are important.

In summary, the majority of underwriters believe that reputation and trust play a strong role in the London insurance market and the underwriters' behaviour influences where brokers place business. Insofar this survey has provided further evidence of the importance of reputation and trust in the London insurance market. Given the small sample it is not possible to draw general conclusions from the responses to the more specific questions

regarding the factors influencing reputation and the correlation between pricing and reputation. In addition, the differences of some of the responses between interviewees and survey participants could be explained by the age gap. The majority of interviewees have long-standing experience in the London market, whereas the age of survey participants was below 40. This difference might indicate that either reputation and trust are to some extent experience related, or that the survey participants have limited underwriting authority (i.e. they may have to refer decisions to a manager), thus reputation and trust are less relevant to the survey participants. Notwithstanding this, there is still value in analysing the responses as they supplement the findings from the interviews.

9 Conclusions and Discussions

9.1 Introduction

The main aim of this thesis was to explore what role reputation and trust play in the decision process of underwriter and brokers in the London insurance market. The way the main research objective was phrased, already implies that reputation and trust play a role. For the insurance sector this is confirmed by, for example, Schanz (2009) and Herger (2006). Through a review of the theoretical literature on reputation and trust combined with interviews with market participants and a survey with underwriters in the London insurance market, there was an expectation that a clearer picture should emerge about how important these two concepts are, how they function, how they interact and how they influence decisions of underwriters and brokers.

This chapter will introduce an influence diagram which summarises the findings with regards to the placing process in the London insurance market and aligns them with theoretical findings on the concepts of reputation and trust, together with a summary of the interviews and the survey amongst underwriters. In addition, the contribution to knowledge will be discussed. Furthermore, suggestions for further research and the limitations of this study will be highlighted.

9.2 Summary of the findings

In Chapter 2, the inner workings of the London insurance market, together with concept of insurance, were explored. The way how insurance business is placed by brokers and the way how underwriters accept business has already provided evidence why reputation and trust may play a more pertinent role in this specific market place. The review of literature on reputation and trust in Chapter 3 came, *inter alia*, to the conclusion that reputation is judgemental in nature and trust functions in a way as to reduce uncertainty in economic transactions and thus the complexity of decisions. Furthermore, the review of existing behavioural decision theories in Chapter 4, which might be relevant for insurance underwriting, came to the conclusion that human beings as economic actors do not always act rationally in the sense of maximising utility because of cognitive limitations, especially when decisions are made under uncertainty, such as

underwriting. As a result, underwriters' decisions will be impacted by cognitive and affective processes which could affect risk perception and judgment. However, underwriters and brokers alike do not make decisions in an ivory tower, but are influenced by social forces within the company in which they work, such as growth ambitions and management power. In addition, the sanction mechanism of reputation and the way trust helps building business relationships in the London insurance market, can impact how underwriters and brokers make decisions. Figure 31 summarises the influencing factors in the London insurance market which impact decision making and also reputation and trust.

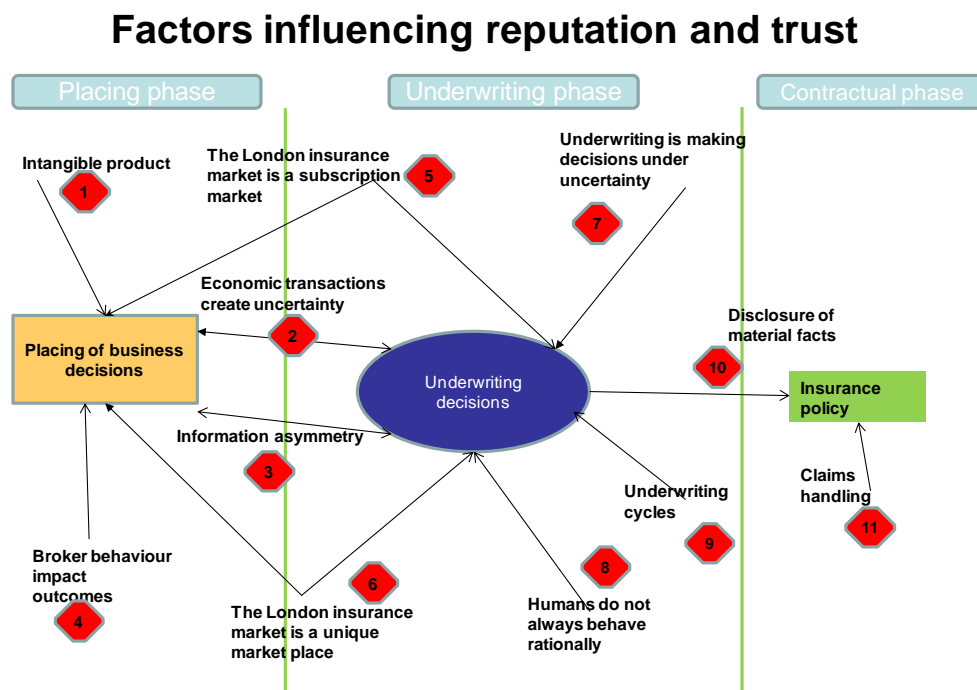


Figure 31 Factors influencing reputation and trust (own diagram)

The influential factors as indicated by numbers in Figure 31 are explained in Table 26 below:

Table 26 Explanation of Figure 32

No	Item	Influential factors
1	Intangible product	Insurance is an intangible product (Farny, 1995) where the ability to evaluate performance attributes is limited (Adler and Weiber, 1995). This could be the ability and the willingness by insurers to pay claims.

No	Item	Influential factors
		<p>There is therefore uncertainty about the quality of the product. (Schulenburg, 2008)</p> <p>Reputation becomes more important where it is difficult to verify product attributes (Eberl, 2006).</p>
2	Economic transactions create uncertainty	<p>Because of limited information available prior to a transaction there will always be an element of uncertainty about the intention of the business partner (Bittl, 1997).</p> <p>This increases the complexity of transactions. Hence trust could be used to reduce this complexity (Ripperger, 1998 and Fichtner, 2006).</p>
3	Information asymmetry	<p>Insurance companies face information asymmetry as brokers and policyholders know more about the risk (Zweifel and Essen, 2012).</p> <p>Adverse selection and moral hazards are two main problems of information asymmetry (Fichtner, 2006) Information asymmetries of the insurer in respect of the future behaviour of the policyholder and about the underlying risk the broker is presenting can potentially be reduced by reputation (Koch et al, 2009)</p> <p>Information asymmetries about the future behaviour of insurers can be reduced through reputation and trust (Herger, 2006 and Schanz, 2009)</p>
4	Broker behaviour impact outcomes	<p>Brokers have a duty of care towards the insurance buyer. Brokers act as 'market maker' (Cummins and Doherty, 2006, p 360) by identifying insurance needs and find the appropriate insurer. This requires a 'significant degree of mutual trust.' (Cummins and Doherty, 2006, p 362)</p> <p>A brokers need to be able to build relationship and trust with clients. Otherwise they will lose the mandate (Maas, 2010).</p>
5	The London insurance market is a subscription market	<p>The London insurance market is a subscription which means that terms and conditions are typically negotiated between the lead underwriter and the broker (CII, 2010).</p> <p>'The broker's job is then to enter the market and find a lead for the risk, an underwriter who will accept the risk and set the rate of premiums and rates' (Thoyts, 2010, p 137).</p> <p>The brokers also needs to 'find the right lead, an underwriter whose expertise in the type of risk is recognised. If the lead underwriter's judgement is trusted, the market will happily follow.' (Thoyts, 2010, p 138).</p>

No	Item	Influential factors
		In business relationships trust is an important feature and functions as heuristics because it 'speeds up decision making and conserves cognitive resources.' (Uzzi, 1997, p 43)
6	London insurance market is a unique market place	London retains an advantage in underwriting expertise and paying claims, proximity of brokers and underwriters (City, 2011). Personal relationship and trust play an important role in 'expert judgement' (Jarzabkowski, 2010, p 3)
7	<p>Underwriting is making decision under uncertainty.</p> <p>These decisions impact the outcome and hence the reputation of the underwriter</p>	<p>Underwriters make decisions under uncertainty (Kunreuther, 2003) as there is uncertainty about the number of claims and the amount of claims payments (Rejda, 2008).</p> <p>Because underwriters make decisions under uncertainty their decision is influenced by cognitive and affective processes which can impact their risk perception and judgment (for example, Epstein (1994) and Slovic et al (2002).</p> <p>Heuristics may be used to reduce the complexity of decisions (Kahneman and Tversky, 1974).</p>
8	Human being do not behave totally rationally when it comes to economic decisions and human beings do have limited cognitive capacity to process information	<p>Rationality would require a choice amongst all possible options. However, actual behaviour shows that human beings consider only a limited number of alternatives (Simon, 1957).</p> <p>Individuals do not have the capacity to process an unlimited amount of information (Fichtner, 2006). Models of rational decision-making ignore human constraints in terms of availability of time, information and the ability to compute information (Dasgupta, 2010).</p> <p>Reputation can be used as information surrogate (Eberl, 2007) which helps to build trust (Dasgupta, 2010)</p>
9	Underwriting cycle	<p>Underwriting cycles are the 'tendency of property and liability insurance premiums, insurers' profits and availability of coverage to rise and fall with some regularity over time.' (Rubin cited in Fitzpatrick, 2003). Fitzpatrick (2003) argues that rational arguments may miss the point as the factors could be as much behaviourally as economically driven.</p> <p>However, the specialist nature of the London insurance market can dampen the volatility of premium rates. For example, AON (2013, p 15) comments on international liability business where 'the quality of the underwriter and client relationship is important on casualty business and consequently most buyers do not move lead markets frequently.' This means that insurance buyers do not change insurers very often.</p>

No	Item	Influential factors
10	Disclosure of material facts	The Law Commission (2012) and Mactavish (2011) criticise the current insurance law on the disclosure of material facts which puts policyholders at a disadvantage because corporate insurance buyers are not aware of the burden on the policyholder.
11	Claims handling	The current duty of disclosure puts insurers at an advantage because it is easier to avoid claims if they seek to (Law Commission, 2012) According to a survey by AIRMIC there is an increasing tendency by insurers to dispute claims on ground of non-disclosure (AIRMIC, 2012) which may leave policyholders stranded (Law Commission, 2012).

The interviews with underwriters and brokers in the London insurance market, as well as AIRMIC, provided rich material to depict how decisions are made in this specialist market and how reputation and trust might influence these decisions. From these interviews it can be concluded that there is strong evidence that reputation influences how underwriters and brokers deal with each other and also whether they deal with each other. Insofar as this is the case, reputation acts as an information surrogate because of the easier availability of reputational information when there is direct experience or when this experience is conveyed through third parties. Reputation also has a sanction function as it influences whether underwriters and brokers trust each other in business relationships.

The interviewees provided a number of examples how the reputation affects the decision-making of underwriters and brokers. It impacts the quality and amount of business underwriters get to see from brokers. The quote of broker (B3) summarises this succinctly:

'If an underwriter is a pain in the arse he will have limited access to good business.'

Conversely, it impacts how underwriters deal with brokers and this can go so far as to a refusal by the underwriter to see a broker.

'[Honesty] increases the chances that the underwriter will oblige to your request. However, if you have a reputation as not being honest, tapping underwriters or being shady you won't get very far.' (B2)

The way underwriters handle claims is also one of the most pertinent drivers of reputation. Although, brokers and corporate insurance buyers may initially select underwriter who offers a lower price, the claims handling experience at a later stage will impact whether brokers and corporate insurance buyers stay with the same underwriter or seek to switch the insurer.

9.3 Contribution to knowledge

The literature review of reputation and trust, together with a description as to how the London insurance market functions, including issues arising from the placing process, has contextualised the role of reputation and trust in this narrow market place. A number of previous studies which were discussed in Section 5.3, such as Keykhah (2000) or Baublyte (2012), looked into underwriting or business practices in the London insurance market and discovered that reputation and/or trust play a significant role in this specialist market. This thesis expanded on previous research by looking into the specific role of reputation and trust in the decision-making processes in the London insurance market. The contribution to knowledge of this thesis can be summarised as follows:

1. Developing a clearer definition of reputation as a judgement of previous actions or behaviour which in turn creates expectations for future behaviour;
 2. Clarifying the interaction between reputation and trust in the decision making process, namely that reputation is a precursor for building trust or mistrust thus alleviating complex decisions.
 3. Establishing trust as a means to reduce the complexity of decision making thus having similar attributes as a heuristic because trust could be regarded as a cognitive shortcut which helps to limit transaction costs and alleviate uncertainty about the outcome of decisions.
 4. Providing evidence with regards to the specific role of reputation and trust in the decision making process in the London insurance market.
-
1. Despite intensifying research into the concept of reputation in the early 1990s, there is still a lack of a widely shared definition of this concept. Based on the literature review

in Chapter 3, some authors emphasise the judgemental nature of reputation, e.g. Gotsi and Wilson (2001). Others highlight the perceptive nature of this concept, e.g. Wartick (2002), and others argue that previous actions create expectations for future behaviour, e.g. Mahon (2002).

The definition developed for the purpose of this thesis clarifies that reputation contains two main elements, namely a judgemental one (i.e. judgement of previous actions) and an extrapolative one (i.e. creating expectations of future behaviour of an individual or an organisation). This is because the judgemental nature of reputation should not be considered in a vacuum, but more as part of a decision making tool. Consequently, the judgemental element of reputation needs to be expanded to involve an element of extrapolation into future behaviour of an individual or an organisation. This suggests an updated definition of corporation of reputation:

Corporate reputation can be regarded as a judgement of various aspects of an organisation's (which includes individual members of an organisation) past actions by its various stakeholders, which will cause these stakeholders to evaluate their (different) expectations about the prospective behaviours of the organisation.

This definition does not only apply to direct experience, but indirectly to, for example new customers or stakeholders, who will judge previous behaviour and form expectations for future behaviour through media or other channels.

2. Similar to reputation, there is still a wide range of academic views on the definition of trust, but also on the mechanics of this concept. Although trust is utilised in every day dealings by individuals or organisations, it appears there is no clarity of what trust really means (Rippperger, 2003). Notwithstanding this, some authors acknowledge that trust is an important part of how human beings cooperate with each other, e.g. Luhmann (2009).

Furthermore some authors consider trust in a similar fashion as reputation, e.g. Bittl (1997), namely as an evaluative tool to make decisions. Some research also introduced trust in the context of reputation without clarifying what is meant by trust. In addition, it is not clear whether there is a correlation between reputation and trust and if a correlation is acknowledged how this correlation works.

Based on how reputation is defined for this thesis as an evaluative and extrapolative concept, trust has to be different from reputation. This thesis sees trust as an antecedent to decision making, as trust provides the confidence for either a positive or negative decision. In terms of the role between reputation and trust, the former contains the necessary information (i.e. evaluation of the past which is extrapolated into the future) which enables individuals or organisations to either trust or mistrust.

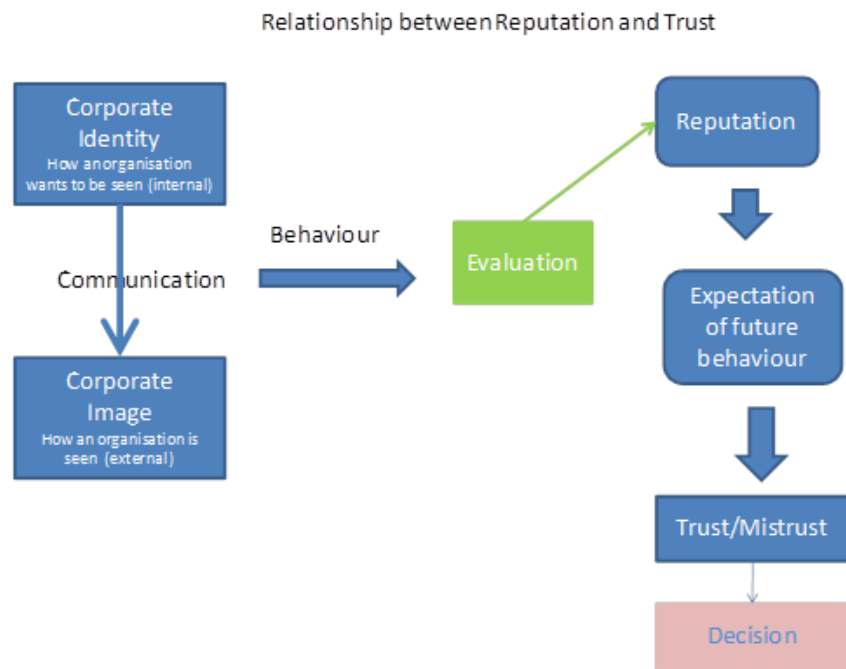


Figure 32 Relationship between reputation and trust (own diagram)

Figure 32 as developed in Chapter 3 makes clear how trust and reputation interact and how both concepts facilitate decision making. This thesis has not provided a separate or new definition of trust, but follows the assertion of Luhmann (2009) that trust can help to reduce the complexity of decision making.

3. This thesis also discussed whether either reputation or trust could be considered as heuristic - not necessarily in the more narrow sense of Tversky and Kahnemann (1974, p 1124) as a means to 'reduce the complex tasks of assessing probabilities and predicting values to simpler judgemental operations', but more in the broader sense offered by Girgenzer and Gaissmaier (2011) as a way of ignoring parts of information in order to expedite decision making - thus reducing complexity. Based on the discussion in section 4.3 it can be concluded that trust has similar attributes as a heuristic because trust helps to reduce the complexity of decision making by reducing uncertainty about the outcome

of a decision. Reputation, on the other hand, should be seen more as an information surrogate because it provides the necessary information to either trust or not trust an individual or an organisation.

4. As the sample size of the interviews was relatively small, it would be difficult to draw general conclusions for the entire London insurance market. Notwithstanding this, the interviews provided rich findings as to the specific role of reputation and trust and how they influence underwriting or broking decisions in the market.

There is a general acknowledgement that reputation and trust play an important role in the decision making in the London market. In addition, the interviews provided evidence that the majority of underwriters and brokers accept that reputation contains judgemental and extrapolative features which in turn facilitates underwriting, broking or buying decisions. This reputational information results either in trusting or mistrusting a business partner. Thus reputation has an information or signalling aspect and a sanction function which impact the formation of trust or mistrust.

Some quotes from the interviews illustrate this:

'Reputation means that individuals or firms are trusted. This can be positive in the sense of providing complete information. It also involves a straightness of information or good claims service.' *'Reputation can be driven by an individual's behaviour. If someone is a bit sharp or close to the wind this can influence the broker/ underwriter relationship.'* (U5)

'I think reputation is entirely capricious; the destruction of reputation is entirely unpredictable. [...] Individual underwriters have a reputation. The reputation of the underwriter will affect the amount and the quality of business they get. If you have an underwriter "who is a pain in the arse", he or she is unlikely to show better business.' (B3)

'Reputation is influenced by how you handle claims, how employees behave or interact with others. Brokers would move business when an insurer has a bad reputation for bad claims handling.' (U2)

'Reputation can be (negatively) impacted when an insurer does not respond adequately, where there is no serious underwriting or when claims handling is unsatisfying. In addition, behaving in the market aggressively is a factor.' (U4)

With regards to the heuristic function of trust there is no conclusive evidence based on the interviews and specific survey questions. However, a limited number of interviewees acknowledged that underwriters cannot go through an entire submission and have to rely on brokers' assurance about the risk to be insured. This was partially confirmed by survey responses. It can be argued that because of time limitations, but also because of cognitive limitations it would be impossible for an underwriter to comprehensively go through the document without making mental shortcuts (e.g. making judgements about the risk depending on which broker had submitted the document). Thus reputation provides information about previous presentation of brokers (for example, a broker may have misrepresented a risk in the past) which in turn creates trust or mistrust thus reducing the complexity of decisions.

Apart from the above mentioned example of trusting the oral and written presentation of a brokers there are other examples where trust plays a specific role in the decision making in the London market:

- There are instances where brokers need provisional cover for a new risk without being able to provide a full submission. Thus brokers would approach an underwriter to get provisional coverage. If the underwriter has a positive reputation a broker will trust the underwriter's verbal confirmation that a risk is provisionally insured.
- Conversely, an underwriter who has been approached by a broker to provide provisional cover may be reluctant to do so, if the broker has acquired a negative reputation. This means the underwriter will not trust the verbal assurances of the broker and is likely to be reluctant to cover the risk without a written submission.

9.4 Overall conclusions

In the theoretical literature explored in this thesis there is a general acknowledgement that reputation and trust are relevant in business transactions because of the inherent uncertainty about business transactions and the behaviour of contractual parties once a contract has been concluded. As a result, it was concluded that in order to reduce this uncertainty reputation and/or trust might be used to either provide information about past behaviour or to facilitate business transaction.

Based on the discussions in thesis, it is undeniable that reputation and trust have a particular role to play in the London insurance market. This is partially because of the intangible nature of insurance which gives to a more prominent role of reputation and trust, but also because of the specific set up of the London market in the City of London. The close proximity of market participants helps to form closer business relationships, and even personal relationships, which in turn enable trust. This close proximity also enables the exchange of reputational information in a relatively short period thus establishing reputation as a sanction mechanism in a negative or a facilitating mechanism in a positive sense. This differentiates the London market from other insurance market places, such as Bermuda.

The fact that reputation and trust are important factors for decision making does not mean that the London insurance market is not susceptible to misbehaviour or errors. For example, there will always be brokers who will take advantage of a weak underwriter and underwriters will make errors when assessing a risk. However, there is a distinction between trust which relies on reputational information to make a decision and 'blind trust' which is created without justification (Ripperger, 2003). In addition, human beings do not (always) behave rationally when it comes to decisions under uncertainty. Notwithstanding this, there is a strong argument that reputation and trust enable a more efficient market, by reducing transaction costs because reputational information is readily available, either through direct experience or through third party experience. The sanction mechanism of reputation also provides an incentive for underwriters and brokers alike to consider their actions before making decisions.

9.5 Limitations of this study and suggestions for future research

Because of the limited number of interviews and would be difficult to extrapolate the findings from these interviews to the entire London insurance market. However, as argued in section 6.7.2 the purpose of this research was to explore phenomena and as such even a small sample size can provide sufficient data to answer the research questions. This should also be seen in the context of the professional experience of the researcher who has had extensive experience as underwriter both in Germany and in the London insurance market. In addition, the researcher had worked for a number of years as an insurance analyst for rating agencies and most recently as insurance analyst for the Financial Services Authority/Prudential Regulation Authority. This extensive professional experience in the insurance sector, both as an underwriter and insurance analyst, has enhanced the researcher's interviewing skills because the in-depth understanding

of the insurance sector and the London insurance market helped to better contextualise the interview responses. This in turn allowed for a spontaneous formulation of follow-up questions during the interview following the interviewees' responses to initial questions. Insofar as this is concerned, it could be argued that this has contributed to the richness of the interview material.

During the interviews, the researcher was careful to maintain a neutral stance on the functioning of reputation and trust, i.e. not to direct interviewees towards the definitions developed for this thesis or towards the researcher's own held views on these concepts.

In order to overcome the above-mentioned limitation, namely the small sample size, further empirical research on the influence of reputation and trust in specific decision situations, both on the underwriting and broking side, would be helpful. Lloyd's of London and a number of London market insurers have previously sponsored research which looked into specific aspects of the London insurance market, such as Jarzabkowski et al (2010) or Weick et al (2012). A commitment by London insurance market organisations, such as Lloyd's of London or the Institute of Underwriters, to support a further study into the specific role of reputation and trust in underwriting and broking decisions in this market place could herald higher response rates as it would allow easier access to underwriters and brokers. It can also be assumed that because of an explicit support by London insurance market organisations or individual insurers or brokers, these sponsors would be interested in the success of the research study. Insofar, these organisations are likely to ensure that a sufficient number of interviews or a sufficient number of surveys could be conducted.

The two reports published by Lloyd's of London on risk perception and behavioural decisions theories indicate that there is increasing interest in understanding how decisions are being made by individual underwriters. However, these two reports lack the empirical evidence and are thus of limited practical value for market participants. Insofar, empirical research on how underwriters make decisions under uncertainty might provide a better understanding of how actual behaviour might fit into behavioural description theories. As pointed out, human beings have limited cognitive capacity, especially when it comes to complex decisions, such as underwriting. Therefore it would be useful for the insurance industry and academics to focus future research in these areas. Such research could be combined with further empirical research on the specific role of reputation and trust in decision making in the London insurance market. Specifically how underwriters make decisions under uncertainty and how reputation and trust influence these decisions as they are inherently linked because of the behavioural aspects of decision making.

Appendices

Appendix A - Sample of Market Reform Contract (MRC) (Source: London Market Group, 2012)

GLOBAL EXAMPLE:

Risk Details:

UNIQUE MARKET

REFERENCE : B0999ABC123456789

TYPE: All Risks of Direct Physical Loss or Damage including Boiler Explosion and Machinery Breakdown insurance.

INSURED: XXXX England Plc.

ADDRESS: Number 1, Big Boulevard, Milton Keynes, UK

PERIOD: Effective from: 1 January YYYY at 12:01pm GMT

To: 1 January YYYY at 12:01pm GMT

INTEREST: Real and Personal Property at the offices of the insured in the UK, Austria New Zealand and Spain, including the additional coverages defined below:

Personal Property of the Insured's Officials and Employees while on the Premises of the Insured

Improvements and Betterments

Business Interruption (Net Profits and / or Fixed Charges)

Ordinary Payroll

Rental Value / Rental Income

Electronic Data Processing Equipment and Machinery

and as fully defined in the contract wording and clauses referenced herein.

LIMITS: GBP 10,000,000 any one occurrence and in the annual aggregate

Program Sublimits schedule:

Flood: GBP 2,000,000
any one occurrence

Boiler & Machinery: GBP 2,000,000
any one accident

Program Deductibles schedule:

Each claim for loss or damage shall be subject to a combined Property Damage and Time Element deductible as follows:

Windstorm / Flood: GBP 2,000

All other perils except for the above: GBP 1,000

INSURED'S

RETENTION: 20% of 100%.

SITUATION: Offices of the insured in the UK, Spain, New Zealand and Austria.

CONDITIONS: *(Any bespoke wording or clauses will form part of this section, whereas model or registered wordings or clauses can be referred to by reference as per the following example)*

XYZ Insurer - Primary Property wording CPROP192 - dated January 2005

NMA 2914 (Amended Perils) Electronic Data Endorsement A (Section two sub-limit USD 100,000,000)

LMA 5019 Asbestos Endorsement

NMA 2962 Biological or Chemical Materials Exclusion

LOSS PAYEE: XXXX Inc. Number 2 Boulevard, Milton Keynes, UK

SUBJECTIVITIES:

The Insured shall provide to the Insurer a property survey report on the insured addresses such report to be prepared by MNO Surveyors ("the Survey"). The Survey shall be so provided by 12:01p.m.GMT on 31 January YYYY ("the Survey Deadline").

Between inception and the Survey Deadline, cover is provided by the Insurer on the terms and conditions specified in the contract to which this condition is attached ("the Contract Terms").

Where the Survey is not submitted to the Insurer by the Survey Deadline, cover shall terminate at the Survey Deadline.

Where the Survey is submitted to the Insurer by the Survey Deadline, cover shall continue from the Survey Deadline on the Contract Terms until expiry of the period of the contract unless and until terminated in accordance with the following paragraph.

In the event that the Survey is unsatisfactory to the Insurer, the Insurer shall have the right, within 14 days of its receipt, to terminate the contract by serving not less than 14 days notice in writing to the Insured at its address shown in the contract, such notice expiring no earlier than the Survey Deadline.

In the event of termination under this survey condition, the Insured shall be entitled to pro rata return of premium for the unexpired period of the contract unless a loss has arisen for which the Insured seeks indemnity under this contract in which case the Insurers shall remain entitled to the premium specified in the Contract Terms.

To the extent that this survey condition conflicts with any other cancellation, notice and premium provision in the Contract Terms, this survey condition shall prevail.

CHOICE OF**LAW AND****JURISDICTION:**

This insurance shall be governed by and construed in accordance with the law of England and Wales. Each party agrees to submit to the exclusive jurisdiction of any competent court within England and Wales.

PREMIUM:

GBP 1,000,000 (100%) Annual

PREMIUM

PAYMENT TERMS: 60 Day Payment condition – LSW 3001 Premium Payment Clause

TAXES PAYABLE**BY INSURED AND****ADMINISTERED****BY INSURER(S):**

(For all taxation headings, where there are a large number of locations and/or taxes applicable then it may be more practical to provide the tax information in an attached spreadsheet/tax schedule, which may then be referenced here.)

UK	IPT at 6% on UK Gross Premium (GBP 550,000)
Spain	Premium tax at 6% (on GBP 200,000 Gross Premium) Consorcio (formerly CLEA) at 1.5% (on GBP 200,000 Gross Premium) Consorcio (extraordinary risks) at 0.021% of the Sum Insured (EUR 13,500,000)
Austria	Premium Tax at 11% (on GBP 50,000 Gross Premium) Fire Brigade Charge at 4% of 20% of Gross Premium apportioned to fire only risks (GBP 10,000)

TAXES PAYABLE**BY INSURERS AND****ADMINISTERED****BY INSURED, OR THEIR AGENT:**

(For all taxation headings, where there are a large number of locations and/or taxes applicable then it may be more practical to provide the tax information in an attached spreadsheet/tax schedule, which may then be referenced here.)

New Zealand	Income Tax at 2.8% (on GBP 200,000 Gross Premium)
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Fire Services Commission Levy 0.076% on New
Zealand Sum Insured (NZD 500,000)

RECORDING,

TRANSMITTING &

STORING

INFORMATION: Where Broker XYZ maintains risk and claim
data/information/documents Broker XYZ may hold
data/information/documents electronically.

INSURER

CONTRACT

DOCUMENTATION: *(An insurer may specify here any insurer contract documentation
requirements that apply to them. e.g. need for a policy, or policy
endorsements, including the policy form to be used.)*

This document details the contract terms entered into by the insurer(s),
and constitutes the contract document.

Any further documentation changing this contract, agreed in
accordance with the contract change provisions set out in this
contract, shall form the evidence of such change

Information Section:

The following information was provided to insurer(s) to support the assessment of the risk at
the time of underwriting.

Client submission dated November YYYY prepared by Producer Inc and seen by all participants
hereon and held on file by Broker XYZ Ltd

No losses past five years

EFG Burglar alarm system installed at all locations

ABC Sprinkler system installed at Milton Keynes location

Security Details

INSURER'S *(This clause LMA3333 should be provided in full and not simply referenced.)*

LIABILITY:

LMA3333

(Re)insurer's liability several not joint

The liability of a (re)insurer under this contract is several and not joint with other (re)insurers party to this contract. A (re)insurer is liable only for the proportion of liability it has underwritten. A (re)insurer is not jointly liable for the proportion of liability underwritten by any other (re)insurer. Nor is a (re)insurer otherwise responsible for any liability of any other (re)insurer that may underwrite this contract.

The proportion of liability under this contract underwritten by a (re)insurer (or, in the case of a Lloyd's syndicate, the total of the proportions underwritten by all the members of the syndicate taken together) is shown next to its stamp. This is subject always to the provision concerning "signing" below.

In the case of a Lloyd's syndicate, each member of the syndicate (rather than the syndicate itself) is a (re)insurer. Each member has underwritten a proportion of the total shown for the syndicate (that total itself being the total of the proportions underwritten by all the members of the syndicate taken together). The liability of each member of the syndicate is several and not joint with other members. A member is liable only for that member's proportion. A member is not jointly liable for any other member's proportion. Nor is any member otherwise responsible for any liability of any other (re)insurer that may underwrite this contract. The business address of each member is Lloyd's, One Lime Street, London EC3M 7HA. The identity of each member of a Lloyd's syndicate and their respective proportion may be obtained by writing to Market Services, Lloyd's, at the above address.

Proportion of liability

Unless there is “signing” (see below), the proportion of liability under this contract underwritten by each (re)insurer (or, in the case of a Lloyd’s syndicate, the total of the proportions underwritten by all the members of the syndicate taken together) is shown next to its stamp and is referred to as its “written line”.

Where this contract permits, written lines, or certain written lines, may be adjusted (“signed”). In that case a schedule is to be appended to this contract to show the definitive proportion of liability under this contract underwritten by each (re)insurer (or, in the case of a Lloyd’s syndicate, the total of the proportions underwritten by all the members of the syndicate taken together). A definitive proportion (or, in the case of a Lloyd’s syndicate, the total of the proportions underwritten by all the members of a Lloyd’s syndicate taken together) is referred to as a “signed line”. The signed lines shown in the schedule will prevail over the written lines unless a proven error in calculation has occurred.

Although reference is made at various points in this clause to “this contract” in the singular, where the circumstances so require this should be read as a reference to contracts in the plural.

ORDER HEREON: 80% of 100%

BASIS OF

WRITTEN LINES: Percentage of whole.

SIGNING

PROVISIONS: In the event that the written lines hereon exceed 100% of the order, any lines written “to stand” will be allocated in full and all other lines will be signed down in equal proportions so that the aggregate signed lines are equal to 100% of the order without further agreement of any of the insurers.

However:

- a) in the event that the placement of the order is not completed by the commencement date of the period of insurance then all lines written by that date will be signed in full;
- b) the signed lines resulting from the application of the above provisions can be varied, before or after the commencement date of the period of insurance, by the documented agreement of the insured and all insurers whose lines are to be varied. The variation to the contracts will take effect only when all such insurers have agreed, with the resulting variation in signed lines commencing from the date set out in that agreement.

WRITTEN

LINES:

In a co-insurance placement, following (re)insurers may, but are not obliged to, follow the premium charged by the slip leader.

(Re)insurers may not seek to guarantee for themselves terms as favourable as those which others subsequently achieve during the placement.

(The above text is recommended for use, directly under the Written Lines heading, within open market multiple insurer contracts).

Each insurer enters their written line here (with continuation pages as necessary)

(Optionally, page numbering of the contract document may cease at the end of the Security Details section where this is preceded by the Risk Details & Information sections i.e. a new numbering sequence may be used in the remainder of the document; incorporating the Subscription Agreement, Fiscal & Regulatory & Broker Remuneration & Deductions sections. It is also optional for the broker to insert a divider at this point.)

Contract Administration and Advisory Sections:

(The above is an optional heading.)

Subscription Agreement Section

SLIP LEADER: ABC Syndicate (nnnn)

(The heading name of Slip Leader, rather than Contract Leader, has been retained in order to maintain consistency with the GUA and other publications).

BASIS OF AGREEMENT

TO CONTRACT CHANGES: GUA (October 2001) with Non–Marine Schedule
(October
2001)

(Note: This existing MRC model text references the applicable contract change agreement practice e.g. GUA or AVS100B).

Wherever practicable, between the broker and each (re)insurer which have at any time the ability to send and receive ACORD messages:

1. the broker agrees that any proposed contract change will be requested via an ‘ACORD

message' or using an ACORD enabled electronic trading platform;

2. whilst the parties may negotiate and agree any contract change in any legally effective manner, each relevant (re)insurer agrees to respond via an appropriate 'ACORD message' or using an ACORD enabled electronic trading platform;

3. where a (re)insurer has requested to receive notification of any contract change the broker agrees to send the notification via an 'ACORD message' or using an ACORD enabled electronic trading platform.

(Note: This new model text promotes the use of ACORD messaging as the means of endorsement submission, agreement and notification).

OTHER AGREEMENT

PARTIES FOR Slip leader only to agree part two changes.

CONTRACT CHANGES,

FOR PART 2 GUA CHANGES

ONLY:

AGREEMENT

PARTIES FOR DEF Company Ltd to agree all contract changes.

CONTRACT CHANGES,

FOR THEIR PROPORTION ONLY:

9.5.1.1.1.1 BASIS OF CLAIMS

AGREEMENT: Claims to be managed in accordance with:

- i) The Lloyd's Claims Scheme (Combined), or as amended or any successor thereto.

(N.B. The applicable Scheme/part will be determined by the rules and scope of the Scheme(s)).

- ii) IUA claims agreement practices.
- iii) The practices of any company(ies) electing to agree claims in respect of their own participation.

CLAIMS AGREEMENT

PARTIES:

- i) For Lloyd's syndicates

The leading Lloyd's syndicate and, where required by the applicable Lloyd's Claims Scheme, the second Lloyd's syndicate and/or the Scheme Service Provider.

The second Lloyd's Syndicate is JKL (1234).

(Where known by the broker, they may insert the second Lloyd's Syndicate name here – or may leave space for the relevant underwriter to apply their stamp below).

- ii) Those companies acting in accordance with the IUA claims agreement practices, excepting those that may have opted out via iii below.

(The companies that apply the IUA claims agreement practices do not need to be individually identified here).

- iii) Those companies that have specifically elected to agree claims in respect of their own participation.

DEF Company

(Where known by the broker, the company(ies) electing to agree claims in respect of their own participation can be recorded here by the broker – otherwise this should be indicated by the relevant company(ies) placing their stamp(s) under this heading).

- iv) All other subscribing insurers that are not party to the Lloyd's/IUA claims agreement practices, each in respect of their own participation.

(Companies that are not a party to the IUA Claims Agreement Practices will be handled under this category; they do not need to be individually identified).

CLAIMS

ADMINISTRATION:

Broker XYZ and insurers agree that any claims hereunder (including any claims related costs/fees) will be notified and administered via ECF with any payment(s) processed via CLASS, unless both parties agree to do otherwise.

RULES AND EXTENT

OF ANY OTHER

DELEGATED

CLAIMS

None, unless otherwise specified here by any of the

AUTHORITY: claims agreement parties shown above.

EXPERT(S)

FEES COLLECTION: ANO Ltd to collect fees for all contract security,
including
overseas.

SETTLEMENT

DUE DATE: 1st April YYYY.

BUREAU

ARRANGEMENTS: (e.g. an appropriate premium processing clause)

Fiscal and Regulatory Section

TAX PAYABLE BY

INSURER(S):

(For all taxation headings, where there are a large number of locations and/or taxes applicable then it may be more practical to provide the tax information in an attached spreadsheet/tax schedule, which may then be referenced here.)

UK	None applicable
Spain	Fire Brigade Charge at 5% of 20% of Gross Premium apportioned to fire only risks (GBP 40,000)

Austria	Fire Brigade Charge at 4% of 20% of Gross Premium
	apportioned to fire only risks (GBP 10,000).
New Zealand	Income Tax and Fire Services Commission administered by the insured/their agent as specified within Risk Details.

COUNTRY OF ORIGIN: UK

OVERSEAS BROKER: None

SURPLUS LINES

BROKER: None

ALLOCATION OF

PREMIUM TO CODING: *(Enter Risk Code(s) and any allocation.)*

P3 (100%)

REGULATORY CLIENT

CLASSIFICATION: Large Risk

Broker Remuneration & Deductions Section

FEE PAYABLE

BY CLIENT?: No

TOTAL BROKERAGE: Z%

OTHER

DEDUCTIONS

FROM PREMIUM: 5% Survey fee payable to XYZ Inc

Appendix B – Guidance on Underwriting Biases

Table 27 Guidance on underwriting biases (Source: Lloyd's, 2010)

No	Issued raised	Lloyd's considerations
1	Dread	What is your gut feel about the proposed scenario? Do you fear it could damage your company or the insurance industry? How are other people reacting to the scenario? Gut feelings are helpful, provided you also seek confirming and disconfirming evidence.
2	Familiarity	You may often hear "this is an old issue" (a current example might be the risks or otherwise of Electromagnetic Fields). Is there new information? Has scientific understanding of the risk changed? Have there been legal developments in related areas that would make a successful claim more likely now? Have contract wordings become less tight since you last reviewed the risk. Does your company write different lines of business now; might other companies in your group now be affected? What's new?
3	Scale	A very large scale event may feel very risky. This may lead to denial or despair. Perversely this can lead to the risk being put out of mind, but left within coverage ("if it does happen we'll have bigger things to worry about"). Can smaller versions of the risk occur; but still do damage we might be expected to survive? Is their probability significantly higher? An example might be the impact of an asteroid on earth. A 300m asteroid would cause devastation, but has a probability of 1 in 50,000; however a 30m asteroid would explode with the force of 2 million tonnes of dynamite and may still cause a large loss - this has a probability of 1 in 250. (source: "Risk", by Dan Gardner)
4	Belief	Where do your colleague's beliefs about the level or risk come from? Might their background, culture, sex, colour or social class be affecting their views? Have you asked a diverse group for their opinions; including wider stakeholders such as different professionals and academics.
5	Venturesomeness	What is your colleague's attitude to risk generally? Do they favour riskier sports or gambling; or do they avoid them at all costs? Might this be affecting their judgement one way or the other?
5	High Benefits?	If a risk has associated high personal benefits then objective assessment may be clouded. If the risk were to occur, what would you lose? Conversely, what action would you have to take to avoid the risk (e.g. exclusion, sublimit, decline the policy, exit the class of business). What would you lose in that case (Bonus? Job? Kudos?). Might anticipated regret in each case be clouding your judgement? What about your colleagues?
7	Group Biases	Is your emerging risks group well balanced and diverse? Does it contain a variety of professional disciplines? (Claims, Underwriting, Actuarial, Risk Management, Policy wording) If not, can you seek external input? The deliberate pursuit of perspectives from different positions (as in De Bono's 'six thinking hats' approach) can be useful, so that the process becomes a conscious and explicit part of the culture of the group.
8	Culture within firm	Is there a learning culture within your firm? If you speak out would it harm your career prospects? Do senior staff exhibit encouraging or inhibiting behaviours regarding risk management? Do they follow the rules and procedures they set?
9	Representativeness	If the risk is new might your colleagues be thinking it is "like" something else? In what sense? Are the similarities superficial or 10relevant to the risk? Are they jumping to stereotypes? Look for differences rather than similarities and ask how significant they could be.
10	Availability	Are there lots of past examples in your personal experience? Or within the corporate memory of the firm? Could you seek examples from other sources or industries? Is there an appropriate proxy? Are near misses tracked? Would a different profession have something to add?
11	Optimism	People tend to assume plans will go well. Have your colleagues considered all the data? Is the plan in line with past experience: did you meet similar targets before? Why are the usual hurdles not expected to apply this time?

No	Issued raised	Lloyd's considerations
12	Hindsight	You may hear " ... if it does happen, we'll cope. We did last time". Did they? Was it due to their actions or some element of luck? What really happened? Are the files available; can they be reviewed? How might things have turned out differently; and how likely was that? Was a review carried out to determine learning points? If not, would that help in future?
13	Confirmation	Have your colleagues looked hard for disconfirming evidence? Can you find someone with the opposite point of view? Why do you discount their assessment? Where possible, does the company track a sample of the risks they have declined? Would they have been more profitable than those accepted?
14	Cognitive Dissonance	If your company is considering a scenario, might this lead to dissonance? For example, they may want to write liability insurance, but previously felt the risks of certain new technologies were too uncertain to be insurable at present. If they are now assessing the risks as lower than before: on what evidence was that based?
15	Estimating Probabilities	<p>Are conditional probabilities involved? Are rigorous Bayesian methods being employed or simple heuristic methods? How would your colleagues perform if asked to estimate the probability in this question:</p> <p><i>There are two bags: (1) has 70% purple balls and 30% white, the other (2) has 30% purple and 70% white. A friend randomly picks a bag by tossing a coin. They then pick 12 balls, one at a time, replacing them as they go. They tell you they picked out 8 purples and 4 whites. Knowing this additional information; what is the chance they picked the first bag?</i></p> <p>Don't let them do the maths: just ask them for their best guess - the point of this is to see how their gut feel is when faced with conditional events.</p>
16	Chain Process	Recall a chain process has a number of interconnecting stages, each with a probability of failure. Can you get information on the individual links and their uncertainty? Could you build a simple model? How did you model the failure rate: were your chosen distributions fat tailed and how would the answer change if they were? If you have aggregated several strands - how did you do you so: what allowance was made for dependency? Did you use a tail dependent copula - what difference did this make? The act of reviewing large claims and catastrophes that have occurred in the past can be very useful. It can highlight the possibility of interaction between previously unconnected factors, and will often illustrate that an adverse outcome was the "impossible" combination of a number of factors - this may help suspend disbelief when considering new scenarios.
17	Scenario Bias	Are your colleagues struggling to think of a robust scenario to illustrate the risk? Is this leading them to conclude adverse outcomes are unlikely? Alternatively has a strong willed member of the group convinced them that a positive outcome is likely by illustrating with a plausible success scenario? Would additional objective evidence help?
18	Halo Effect	How do your colleagues appear to feel about the risk? Does some aspect seem to attract them? (For example a genetically altered seed may promise to solve famine problems - a clearly desirable outcome). Might the positive elements of the risk be affecting their perceptions? Do the positive elements have any bearing on whether adverse outcomes could occur?
19	Redundant Inputs	Is there a lot of apparent evidence that the risk is low? Examples might be: lack of past claims, low media attention, few court cases in the past, no clear adverse scenario. In this example these are arguably not four facts but one driver- the lack of events. These would drive media attention, claims, cases and help bring scenarios to mind. Might there be a long term risk about to emerge?
20	Framing	<p>How was the risk presented? Was positive language used? An example might be:</p> <p><i>" ... we have to write this policy because it is expected to be ~ brings ~ that would give ~ to your colleagues. It fits in with our ~ and demonstrates we are ~ in this field."</i></p> <p>How might your response be different if it was presented as:</p> <p><i>" ... we should be careful when writing this policy because <u>losses</u> could be very large,</i></p>

No	Issues raised	Lloyd's considerations
		<i>which, given planned volumes, could~. It may cause us to ~ and illustrate that we have a~ of the facts, ~ our reputation."</i>
21	Anchoring	Where did that assumption come from? Was this what we assumed last year? Was it based on evidence and data? Or a rough estimate under pressure in a meeting? Did the person making the estimate know what it would be used for? Have any parameters been tweaked to bring the answer from a new model closer to initial expectations? Why are those expectations thought to be more accurate? One response would be to consciously shift anchoring by rephrasing the problem as another factor that might be relevant is identified. For example when considering the impact of Climate Change on insurers you can start from physical effects, economic effects, impacts on global security, opportunities from new low carbon industries etc.
22	Emotion	It is unusual in business to consider emotion; but it can be useful and very relevant as research suggests. The way you feel may affect your attitude to risk. Are you tired, under pressure, stressed, angry, is your mind elsewhere? Self-awareness is the first step to controlling this potential bias in yourself and spotting it in others.
23	Communication	You may need to convince your Board of the appropriateness of a proposed scenario. Remember that they are also subject to the same biases as you and your colleagues. Do they trust you? Are they usually swayed by evidence or more vivid personal descriptions? Do they tolerate uncertainty - or does that undermine your presentation? As with all communication understanding your audience is critical.
24	Group Influence	Did you seek the views of individuals before a meeting at which you discuss emerging risks? This may be a useful step. Then track how their views changed during the meeting and ask them why. Has group think been beneficial; or served to dilute initial feelings? Did peer pressure have a role?

***Appendix C* Scope of the interview with underwriters**

The purpose of this interview is to get a better understanding how reputation and trust might influence underwriting decisions. In particular, I am interested in answers to the following questions:

- Initial question: How do you define reputation
- Whether the underwriting process has changed in recent years.
- Your view on reputation and what role it might play in the underwriting process.
- Whether there is a difference in approach when receiving submissions from different insurance brokers (e.g. in terms of pricing or warranties).
- Whether underwriting considerations vary by type of risks, location or client.
- Whether there is a different approach to risks which have not previously been placed by regular brokers.
- Whether there is a different approach to underwriting depending on the underwriting cycle or market competition?

However, these questions should not be regarded as company specific issues, but rather as potentially providing me with a general view of how the London market operates and whether reputation is part and parcel of this process. I am aware of the confidential nature of insurance placement negotiations and I am not looking for individual examples of underwriting decision behaviour, nor am I looking for commercially sensitive information.

Appendix D – Design of questionnaire

Research question/objective: To establish what role reputation and the similar concept trust play in the insurance underwriting process			
Type of research: Predominantly exploratory			
	Investigative question	Variable(s) required	Detail in which data measured
Section I Q 1	Do underwriters understand the concept of reputation	Opinion of underwriters about reputation	Provide definitions from previous interviews and literature review plus an open answer option
Q 2	Do underwriters understand the concept of trust	Opinion of underwriters about trust	Provide definitions from literature review plus an open answer option
Q 3	Do underwriters understand how reputation and trust are connected	Opinion of underwriters whether reputation and trust interact	Provide definitions from literature review plus an open answer option
Q 4	What role does reputation play in the underwriting process	Opinion of underwriters about role of reputation when dealing with brokers	Provide pre-defined answers, based on previous interviews and existing research plus an open answer.
Q 5	What role does trust play in the underwriting process	Opinion of underwriters about the role of trust when dealing with brokers	Structure of questions as per questions 4
Q 6	How does underwriting and reputation interact	Opinion of underwriters about the interaction of reputation and underwriting	Provide context for underwriting decision
Section II Q 1	How does the reputation of a broker influence underwriting decisions (1)	Opinion of underwriters when faced with a broker who struggles to find capacity	Provide alternative closed answers. Example: 'If the broker has a good reputation I do him a favour and underwrite the risk'
Q 2	How does the reputation of a broker influence underwriting decisions (2)	Opinion of underwriters when faced with a new risk presented by a broker	Provide alternative closed answers. Example: 'If the broker has a good reputation I would trust his/her presentation without going through the whole document.'
Q 3	How do underwriters react when a broker breaks the trust of the underwriter	Understand how underwriters reacted in such a situation	Provide alternative answers plus open choice. Example: 'I refuse to deal with the broker in the future.'
Q 4	How does the state of the insurance market (soft or hard) influence underwriting decisions	Understand whether reputation is of less importance when markets are soft	Provide alternative answers plus an open choice. Example: 'If there is a hard market the reputation of the broker plays a bigger role.'
Q 5	Does the reputation of a broker play a different role	Understand whether there is a difference when brokers present new business or renewable business	Provide alternative closed answers.

	depending on new or renewal business		
Q 6	is there a difference in the role of reputation depending on the line of business	Understand whether the importance of reputation differs by lines of business	Provide closed answers (always important, short-tail and long-tail) plus open answer.
Q 7	Is there a difference in the role of reputation depending on the complexity of the underwriting proposal	Understand whether the role of reputation changes if risks or not complex or very complex	Provide alternative closed answers.
Q 8	Is there a difference in the role of reputation depending on the market share of the broker	Understand whether larger brokers have more influence in the London insurance market than other brokers.	Provide alternative closed answers.
Section III Q 1	Factors influencing underwriter reputation	Understand how underwriters view their own behaviour	Provide factors (e.g. speed of claims settlement) and provide scaling answers (e.g. extremely important)
Q 2	Specific underwriter behavioural situation	Understand how underwriters consider their own behaviour if they switched into the broker's role	Open answer
Q 3	Correlation between underwriting competence and claims service from a broker perspective	Understand how underwriters see this correlation from a broker's point of view	Open answer
Q 4	Underwriters' perspective of factors influencing brokers' decision to place business	Understand what underwriters see as important factors for brokers	Provide factors and provide scaling answers (e.g. fully agree).
Q 5	Reputation of lead underwriters and follower decision	Understand whether underwriters regard the reputation of the lead underwriters as important factor for follow underwriters	Provide alternative closed answers plus open answer.
Section IV Q 1	Age group	Understand whether answers differ by age group	Age band
Q 2	Industry experience	Understand whether answers differ depending on industry experience	Bandings of years worked in the insurance market
Q 3	Underwriting experience	Understand whether answers differ depending on underwriting experience	Bandings of years worked as underwriter
Q 4	Lines of business	Understand whether responses differ by line of business	Samples of lines of business plus an open answer
Q 5	Gender	Understand whether there is a difference in response depending on gender	Male/female choice

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