Buying Insurance: Evolving Distribution Channels

MARCH 2017

UP FRONT

- **Insurance is generally bought directly through an insurer (through its captive agents, the web or other direct channels) or through independent agents and commercial brokers who provide access to the products of several insurers**
- **Direct writers dominate auto and homeowners insurance sales, accounting for 72.4 and 68.4 percent, respectively, of net premiums written in 2015, according to A.M. Best.**

THE TOPIC

Many insurance companies use a number of different channels to distribute their products. In the early days of the U.S. insurance industry, insurers hired agents, often on a part-time basis, to sign up applicants for insurance. Some agents, known nowadays as ?captive? or ?exclusive? agents, represented a single company. Others, the equivalent of today?s independent agent, worked for a number of companies. At the same time that the two agency systems were expanding, commercial insurance brokers, who were often underwriters, began to set up shop in cities. While agents usually represented insurers, brokers represented clients who were buying insurance.

These three distribution channels (captive agents, independent agents and brokers) exist in much the same form today. But with the development of information technology, which provided faster access to company representatives and made the exchange of information for underwriting purposes much easier, alternative distribution channels sprang up, including direct sales by telephone, mail and the Internet. In addition, insurers are using other types of outlets, such as banks, workplaces, associations and car dealers, to access potential policyholders.

RECENT DEVELOPMENTS

- **Life Insurance Sales:** Eighty-eight percent of consumers said they would use the internet to research life insurance before purchasing coverage in 2016, about the same number as a year earlier, according to the *2016 Insurance Barometer Study* survey by the Life and Health Insurance Foundation for Education (LIFE) and LIMRA.. Ninety-five percent of millennials would use the internet to research life insurance. That amount falls for older age groups, down to 70 percent for consumers age 65 and older. Although half of consumers prefer to purchase life insurance in person with a financial adviser, the second most popular method was online, with 21 percent of respondents preferring this method.

P/C DISTRIBUTION

A.M. Best organizes insurance into two main distribution channels: agency writers and direct writers. Its agency writers category includes insurers that distribute through independent agencies, brokers, general agents and managing general agents. Its direct writers category includes insurers that distribute through the internet, exclusive/captive agents, direct response and affinity groups.

- In 2015 direct writers accounted for 51.4 percent of P/C insurance net premiums written and agency writers accounted for 46.1 percent, according to A.M. Best.*
- In the personal lines market, direct writers accounted for 71.2 percent of net premiums written in 2015 and agency writers accounted for 27.0 percent. Direct writers accounted for 68.4 percent of the homeowners market and agency writers accounted for 27.9 percent. Direct writers accounted for 72.4 percent of the personal auto market and agency writers accounted for 26.6 percent.*
- Agency writers accounted for 67.1 percent of commercial P/C net premiums written, and direct writers accounted for 29.5 percent.*

*Unspecified distribution channels accounted for the remainder.

Traditionally, there has been a distinction between agents and brokers, with agents (whether captive or independent) representing the insurance company and brokers representing the client. Recently, the line between agencies and brokers has blurred, with intermediary firms operating as brokers and agents, depending on their jurisdiction and the type of risk.

LIFE INSURANCE DISTRIBUTION

- In 2015 independent agents held 50 percent of the new individual life insurance sales market, followed by affiliated (i.e., captive) agents with 39 percent, direct marketers with 6 percent and others accounting for the remaining 5 percent, according to LIMRA, a life insurance trade association.

Life Individual Market Share By Distribution Channel, 2006-2015

(Based on first year collected premiums)

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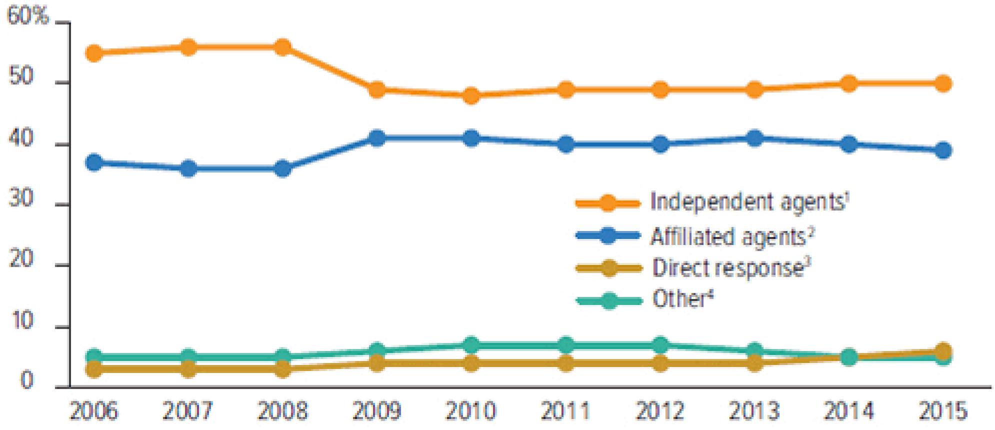

(1) Includes brokers, stockbrokers and personal producing general agents.
(2) Includes career, multiline exclusive and home service agents.
(3) No producers are involved. Excludes direct marketing efforts involving agents.
(4) Includes financial institutions, worksite and other channels.

Source: LIMRA?s *U.S. Individual Life Insurance Sales Survey* and LIMRA estimates.

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ANNUITY DISTRIBUTION

- Insurance agents, including career agents, who sell the products of a single life insurance company, and independent agents, who represent several insurers, account for 37 percent of annuity sales in 2015. State and federal regulators require sellers of variable annuities to register with the Financial Industry Regulatory Authority (FINRA) and the Securities and Exchange Commission.

Sales Of Individual Annuities By Distribution Channels, 2011 And 2015

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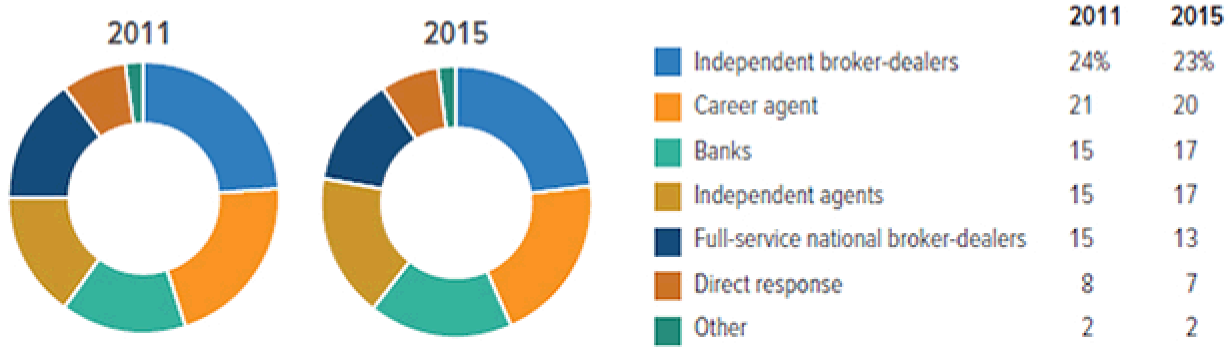

Source: *U.S. Individual Annuity Yearbook - 2015*, LIMRA Secure Retirement Institute.

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WORKSITE MARKETING

- Worksite marketing is the selling of voluntary (employee-paid) insurance and financial products at the worksite. The products may be on either an individual or group platform and are usually paid through periodic payroll deductions.Worksite sales of life and health insurance totaled $6.89 billion in 2014, up about 3.7 percent from 2013.

WORKSITE LIFE INSURANCE SALES BY LINE OF BUSINESS, 2014

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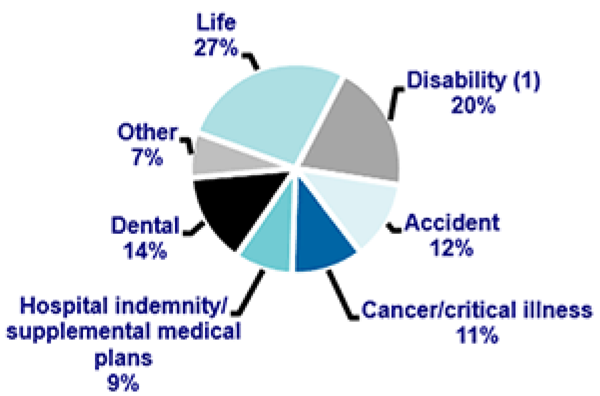

(1) Short-term and long-term disability.

Source: Eastbridge Consulting Group, Inc.

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BANKS IN INSURANCE

- Total life insurance premiums sold through financial institutions fell by 27 percent from $1.6 billion in 2012 to $1.2 billion in 2013, according to BISRA. Liberty Life of Boston was the leading underwriter of life insurance sold through banks, with $400.9 million in new premiums in 2013, followed by Great West L & A ($270.4 million), OneAmerica ($119.4 million) and the Western & Southern Group ($61.8 million).

BANK INDIVIDUAL LIFE INSURANCE SALES, 2009-2013 (1)

($ millions)

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(1) Based on total new premiums.

Source: Bank Insurance and Securities Research Associates (BISRA).

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BACKGROUND

Early Distribution Channels, Property/Casualty Insurance: Risk sharing is not new. Various kinds of insurance enterprises have existed on and off for many centuries. The first U.S. insurance plans were organized around membership in an organization. In 1736 the Friendly Society, operating under a Royal Charter from England, was formed as a mutual company in South Carolina. It covered the fire losses of its members, who contributed directly to a fund that paid claims. However, the Friendly Society?s existence was short-lived. It was dissolved six years later after a fire in Charleston destroyed hundreds of buildings.

Benjamin Franklin set up the first successful U.S. insurance company whose policies could be purchased by the public. Established in Philadelphia initially for the benefit of members of the Union Fire Company, its members voted to open it up to citizens outside of the organization after it had been in operation for a year or so.

In February 1752 a notice was printed in Franklin?s newspaper asking people who were interested in subscribing to the terms and conditions of a new mutual fire insurance company to appear at the Court House in Philadelphia. The first meeting of the subscribers, which included many prominent citizens of the city, was held in March. Among other business was a decision to call the company ?the Philadelphia Contributionship for the Insurance of Houses from Loss by Fire.? The first policy was issued in June of that year.

Soon, other mutual insurance companies were formed, followed by stock companies. The Insurance Company of North America (INA), the first U.S. stock insurance company, was founded in 1792. At first it sold only marine insurance but soon offered fire insurance as well and was the first company to insure both buildings and their contents. A few years later, in 1795, the first U.S. insurance agency opened in Charleston, South Carolina. Known as Davis & Reid, and later as the Vigilant Insurance Office, it advertised that it offered a choice of ?underwriters,? entities that assumed the risk.

As the population expanded and moved further away from the East Coast, where most insurers were based, the need for a formal distribution system grew. Companies created networks of agents, assigning them specific geographic areas, and set up branch offices managed by general agents, later known as ?managing general agents,? or MGAs. Agents? compensation changed from fees for applications to percentage commissions on premiums collected.

The Hartford was the first insurer known to have attempted direct marketing. Founded in 1810, it had an agency network but wanted to expand into areas not serviced by its agents. In an early advertisement, it announced that people who lived in areas where the company had no agent might apply through the Post Office directly to the Secretary of the company. But its efforts were unsuccessful. Apparently people were not ready to buy this new product through the mail.

As the industrial revolution progressed, the growing complexity of the business world spurred the growth of the insurance brokerage business. Most of the country?s major brokerages came into existence in the 19th century, starting with Johnson & Higgins in New York City in 1845. The firm became part of what is now Marsh Inc. in 1997.

As the 19th century came to a close, the first liability policies were issued: employer liability was followed by auto liability insurance. The introduction of liability insurance led to further expansion of the insurance business and to greater specialization among distributors, with general agents mostly selling liability insurance and independent agents fire insurance.

Today, all agents are licensed by the states in which they do business and sell whatever coverages the companies they work with offer. Independent agents sell more commercial lines insurance than personal lines (auto and home insurance). The reverse is true for captive agents. Managing general agents tend to focus on commercial risks and often have authority from the insurance companies they work for to accept business on their behalf, subject to certain terms and conditions. Large brokers focus on commercial lines.

Distribution Channels Evolve: Over the decades, distribution systems have changed. Some insurance companies that started in business using their own sales force switched to independent agents because as companies started to write business in unfamiliar locations, they needed to rely to a greater extent on local people who knew the area.

The term ?captive? or ?exclusive? agent has become associated with companies known today as direct writers. One major difference between captive and independent agents is that the independent agent rather than the insurer legally owns access to policy renewals. Captive insurance agents may be employees of the company or independent contractors.

The concept of direct writers developed at the beginning of the 20th century. Generally, they were mutual companies that sold insurance to farmers and others in specific agricultural businesses, such as millers, at a time when a quarter of the nation?s population lived on farms. Because they were familiar with the risks, they were able to undercut the competition. Many of the direct writers, which are today among the largest auto and home insurers, began by selling auto insurance directly to farm bureaus in the 1920s. Among the best known are State Farm, Nationwide, American Family and Farmers. Other companies such as the United States Army Insurance Association, now USAA, sold to the military and yet others sold to state automobile clubs.

Nowadays, the term ?direct writer? may apply to any company using captive or exclusive agents, as well as companies selling directly to consumers through the mail, Internet or through telephone solicitations, although technically the latter are ?direct marketing? or ?direct response? companies. These direct response companies use salaried employees or company representatives to interact with consumers offsite, whereas agents generally conduct some business with their policyholders face-to-face in their office. GEICO, one of the largest auto insurance companies that today markets directly to consumers, started in 1936 as the Government Employees Insurance Company, selling to government employees and some military personnel.

As the number of companies opting to use multiple channels grows, categorizing a company as a direct writer or agency writer is becoming less helpful. Among the first direct writers to use independent agents to sell in rural areas, where it may not be profitable for a direct writer to set up an office, was Allstate, in 1974. A decade later, in 1983, the Hartford began to market its personal lines products directly to what was then the American Association of Retired Persons, now known solely by the acronym AARP.

Both agents and brokers are known as producers. Traditionally, agents have represented the insurance company and brokers have represented the client, but the line between the two is no longer clear-cut. Generally, it is the broker?s responsibility to seek out appropriate insurance coverages for the client and obtain the best overall price, terms and conditions, but sometimes brokers have agreements with insurance companies.

In addition to the agents and brokers who work for or who represent traditional insurers, there are agents and brokers working for surplus lines companies. The surplus lines market exists to insure risks that licensed companies decline to insure or will only insure at a very high price, with many exclusions or with a very high deductible.

Brokers may be retail or wholesale. Wholesalers act as intermediaries between retail brokers or agents and insurance company underwriters. To work with surplus lines companies, wholesale brokers must be licensed as surplus lines brokers in the state where the policyholder or the risk to be insured is located. Wholesale brokers may also work with other wholesale brokers in the London Market or elsewhere to secure coverage.

Wholesale brokers may also be managing general agents, who are given authority by insurers to underwrite and ?bind? insurance?provide temporary coverage until an insurance policy can be issued. Managing general agents, who have a close relationship with the insurance companies they work with, may also handle claims and even help in the placement of reinsurance contracts?reinsurance is insurance for insurance companies. Managing general agents may also arrange so-called ?program? business, which is specialty insurance for homogeneous groups of policyholders, such as members of a specific industry. These programs, often offered and endorsed by trade associations, may provide coverage at lower prices.

The Life Insurance Industry: Beginning in the mid-1870s, the life insurance industry developed along the same lines as the property/casualty side of the business, using captive agents to sell their products. But unlike agents who sold property/casualty insurance, life insurance agents often collected premiums at the home, on a weekly or monthly basis. This form of distribution flourished until after World War II, when home service agents were gradually displaced by a type of independent agent known as the ?personal producing general? agent. Over time, the number of agents closely connected to one life insurer began to decline.

New Distribution Channels: In the early days of insurance, insurance policies were sold at banks. But the 1916 National Bank Act limited banks? sale of insurance, except in small towns. In the 1990s various court decisions allowed banks to get back into the business of selling insurance, culminating in the 1999 Gramm-Leach-Bliley Act, which said that banks, insurance companies and securities firms could affiliate and sell each others' products. Since that time banks have bought hundreds of insurance agencies and brokerages, and bank sales of all kinds of insurance have grown significantly.

Life insurers began to market life insurance and annuities through banks (mostly fixed annuities, which are similar to other bank products) and financial planners or advisers in the 1990s. A large portion of variable annuities, which are based on securities, and a smaller portion of fixed annuities are now sold by stockbrokers. In three states, Connecticut, Massachusetts and New York, consumers can purchase small life insurance policies directly from savings banks, without going through commissioned salespeople. This practice, which other states refused to follow, began in the early 1900s.

It is not uncommon for insurance companies to make arrangements with various entities, in addition to banks, to make their products available; they include workplaces, associations, car dealers, real estate brokers, pet shops and travel agents, among others.

Advances in Communications Technology: Starting with the telegraph, and then the telephone, advances in communications technology have facilitated the transmission and exchange of information for underwriting and settling claims, enabling insurance agents and other intermediaries to perform their tasks with greater speed and reliability.

With the introduction of the Internet in the 1990s, insurers began offering policies online. As consumers began to be increasingly comfortable purchasing products of all kinds over the Internet, online aggregators began to appear. Aggregators collect information on prices, generally for auto insurance and term life insurance, which are the most standardized, so that consumers can compare the cost of coverage from one company to another. Eventually, many agency companies as well as direct writers began to offer Internet platforms, making it possible for consumers to purchase an insurance policy directly online without the aid of an intermediary.

Regulation: The insurance business is regulated by individual states. Insurance agents and brokers must be licensed to do business in the state in which they conduct business. To be licensed, producers must comply with the state?s requirements, including professional educational mandates. Each state also has regulations governing the termination of agents by insurance companies. Most states base their rules and regulations on a National Association of Insurance Commissioners model law, but many have additional requirements.

While there is no national producer licensing system, over the years there have been efforts to make licensing more uniform and to streamline the approval process. In 1996 the National Association of Insurance Commissioners established the National Insurance Producer Registry to develop and operate as a national repository for producer licensing information. In 1999 standardization was given another push with the passage of the Gramm-Leach-Bliley Act (GLB). GLB would have established a National Association of Registered Agents and Brokers (NARAB) if a minimum of 29 states had not passed reciprocity laws for agent licensing by 2002. While 29 states met the requirement in time, the push for uniformity has continued. In September 2013 the U.S. House of Representatives approved HR 1155, the National Association of Registered Agents and Brokers Reform Act of 2013. If enacted, the law, known as NARAB II, would establish a nonprofit board with the power to grant insurance agents and brokers approval to operate on a multiple state basis if they met certain qualifications and were fully licensed in their home state. The Senate is currently considering similar legislation.

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