3

Types of Insurers and Their Marketing Systems

Learning Objectives

An understanding of the material in this chapter should enable the student to

3-1. Distinguish among the ways private insurers may be classified and organized.

3-2. Compare stock and mutual insurance companies with other types of insuring organizations.

3-3. Explain why some mutual insurance companies are converting to stock companies.

3-4. Briefly describe the insurance market.

3-5. Describe and compare the types of marketing representatives in insurance.

3-6. Explain an insurance agent's legal duties to an insurer and an insurer's duties to the agent.

3-7. Compare the marketing systems used in insurance.

Financial planners play an important role in identifying their clients' risks and assisting their clients in risk management. A financial planner cannot function effectively without understanding one of the major tools of financial planning: insurance. The balance of this book deals primarily with insurance. This chapter and the next two examine the structure of the business that produces and/or sells the insurance products that individuals, families, and businesses need. Financial planners who wish to serve their clients effectively must understand not only insurance products and services but also the structure and organization of the business that delivers them.

TYPES OF PRIVATE INSURERS

The following pages summarize the characteristics of the major types of insurers that make up the United States insurance business. Throughout this book, the terms "insurer," "insurance company," and, often, "company" are used to identify the organization that issues insurance "contracts" or "policies." The choice of words often depends on the context.

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As explained in this section, any private insurer—as opposed to a government insurer—can be classified according to the lines of business it writes, its state or country of domicile, and its form of organization.

Insurance companies can also be categorized in a variety of other ways not specifically discussed here. For example, a given insurer may write business within one county, within a state, within a region, or nationally. An insurer may focus on providing insurance for a particular market segment, such as farmers or teachers, or it might market its products broadly. Some insurers are very selective in their underwriting and provide low-cost insurance to applicants who qualify as preferred risks; other insurers concentrate on the high-risk or substandard-risk market. Some provide an elite set of products designed for wealthy clients, while others market heavily to wage earners. To the client, all insurance companies may seem alike. Experienced financial planners, however, discover that each insurance company has its own personality or flavor, and they often become adept at helping clients find insurers that best match their specific needs. One especially important distinguishing characteristic of any given insurer is its marketing system or systems. Insurer marketing systems are discussed in a later section of this chapter.

Classification by Line of Business

Private insurers can be classified according to the lines of insurance they write. Any given insurer might, for example, be categorized in one of the following ways:

- a life and health insurer
- a property and liability insurer
- an all-lines insurer (writing life, health, property, and liability insurance)
- a monoline specialty insurer (specializing in one line of coverage, such as medical professional liability insurance)

Many insurers have groups of affiliated companies, often with a common field force, that write and sell all lines of insurance.

Classification by Domicile

These classifications are used to classify insurers operating in the United States:

domestic insurer

foreign insurer

alien insurer

- A *domestic insurer* is one doing business in the state where it is incorporated. For example, New York Life Insurance Company is classified as a domestic insurer when it does business in New York.
- A *foreign insurer* is one doing business in a state other than its state of incorporation. Hartford Fire Insurance Company, domiciled in Connecticut, is a foreign insurer when doing business in New York. New York Life Insurance Company is a foreign insurer when it does business in Connecticut.

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- An *alien insurer* is incorporated in another country but doing business in the United States. An insurance company domiciled in Germany is an alien insurance company when it does business in New York.

Admitted versus Nonadmitted Insurers

nonadmitted insurer

An admitted insurer is one that is licensed by a state insurance department to do business in a policyowner's home state. A *nonadmitted insurer* is one that is not licensed or authorized in the policyowner's home state. However, a nonadmitted insurer might be licensed in other states, and it might even be an alien insurer (that is, it might be licensed in another country).

surplus lines insurance

Nonadmitted insurers serve a legal, valuable, and positive role in the U.S. insurance marketplace. A typical nonadmitted insurer provides *surplus lines insurance* (also referred to as *excess lines insurance*) coverages that otherwise would not be available. Consumers are permitted to buy property and liability insurance from nonadmitted insurers when they cannot purchase some needed coverage from an admitted insurer. Nonadmitted insurers generally provide insurance for policyowners that present underwriting challenges, have unique risks that are hard to evaluate, or require unusually high limits of insurance.

Because they are exempt from many regulations and laws that apply to licensed insurers, nonadmitted insurers generally have more flexibility than admitted insurers; however, the excess and surplus lines market is still subject to regulation. Many states maintain a list of nonadmitted insurers that are approved to do business in the state.

Ways to Classify Private Insurers

- By lines of insurance written—for example, life and health, property and liability, monoline, all lines
- By domicile—for example, domestic, foreign, alien
- Admitted versus nonadmitted insurers
- By legal form of organization—for example, stock, mutual, and so on
- By marketing system

Classification by Form of Organization

Private insurers can be divided into three major groups, according to their legal form of organization:

- stock
- mutual
- other

"Other" insurers include reciprocal exchanges, captive insurers, fraternal societies, banks, health associations, and Lloyd's associations.

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Stock Companies

stock insurance company

A *stock insurance company* is a corporation owned by stockholders. Shares of stock companies are usually traded on an organized stock exchange. Stockholders expect to earn a profit from their investment in insurance company stock. The stockholders elect the members of the company's board of directors and vote on other major issues facing the company, such as mergers or acquisitions.

As with other types of insurers, insurance laws enacted by the various states govern the company's operations. To be licensed, stock insurers must have at least a specified amount of capital and surplus. Stock companies issue insurance contracts in exchange for a premium. The policyowner usually receives no dividends from the company's earnings. Except for participating policies (those with dividends) issued by some stock life insurers, the policyowner's first cost is usually the final cost.[11]

Stockholders are entitled to any of the residual profits declared by the board as dividends after losses and expenses have been paid and proper reserves established.

Stock insurance companies thus have the following basic legal characteristics:

- They are incorporated and owned by stockholders who supply capital funds that serve as part of the financial security for the firm's operations.
- Except for flexible-premium contracts, they usually issue contracts for a fixed cost. The contracts are usually nonparticipating.
- They can pay residual profits to the stockholders.

Mutual Companies

mutual insurance company

A *mutual insurance company* is a not-for-profit insurance company owned by its policyowners. The policyowners also participate in the operations of the company, at least through voting rights, and they share in the company's financial successes and, sometimes, its failure. A mutual insurance company is organized primarily to provide insurance for its policyowners, rather than to seek a profit. Every policyowner is an owner of the company. There are no stockholders. The mutual policyowners elect the board of directors, and the board chooses the executive officers who actually manage the company. The mutual corporation assumes the risks of its policyowners. When the premiums in a given period are more than adequate to meet losses and expenses, part or all of the excess may be returned to the policyowners as a dividend. When

11. In some commercial lines, such as workers' compensation insurance, the insured's first cost takes the form of a tentative deposit premium that is subject to adjustment after an audit at the end of the period of protection. Large commercial insureds might also have loss-sensitive insurance programs, in which the ultimate premium is based in part on the insured's losses during the current policy term.

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premiums are inadequate, dividends may be omitted and, in a few cases, assessments can be levied on policyowners.

Mutual insurers include (1) advance-premium mutuals and (2) assessment mutuals.

advance-premium mutuals

Advance-Premium Mutuals. Advance-premium mutuals write all but a small percentage of total mutual insurance. The operations of *advance-premium mutuals* closely resemble those of stock insurance companies. Legally, advance-premium mutuals are different because they are owned by the policyowners and have no stockholders.

Advance-premium mutuals issue nonassessable contracts in which the cost of the insurance is set when the policy begins. Legal requirements for writing nonassessable policies require these mutuals to possess specified amounts of surplus to ensure the company's financial solvency in case of temporary periods of heavier-than-normal losses or expenses.

Advance-premium mutuals may issue dividends to policyowners. At the end of the policy period, a return may be made as a dividend for any amount beyond the company's losses, expenses, and reasonable contributions to reserves and surplus. The actual amount of the return is unknown to the policyowner until after the insurance contract expires, and it depends on the company's experience for that policyowner classification. The actual net cost (original premium minus dividend) to the policyowner is thus uncertain until the dividend is paid.

In most states, advance-premium mutuals must comply with the same reserve, investment, policy form, and regulatory laws as stock companies. Organizational requirements are somewhat different, in that a minimum number of policyowners is required to start a company, and the board of directors must be subject to the control of policyowners rather than stockholders.

assessment mutuals

Assessment Mutuals. Some small mutual companies are called *assessment mutuals*. Policyowners may or may not pay an advance premium, but they can be assessed for a portion of the company's losses and expenses at the end of the policy period. The policyowner's liability for the assessment may be limited or unlimited with an assessment mutual.

Choosing between the Stock and Mutual Form

From the standpoint of the insurance consumer, which type of insurer is better—a stock company or a mutual company? Neither type is inherently superior. The stock form of organization may entail lower initial premiums than the mutual form, and a stock company may be better equipped to raise the capital needed for insuring, both initially and subsequently. The mutual form, on the other hand, may charge lower premiums net of dividends because of its nonprofit status. Stock and mutual insurance companies both purchase reinsurance to ensure financial strength. The real issue for the consumer of

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insurance, then, is which specific insurer and which specific insurance contract to select, not which type of insurer to select.

From the standpoint of the insuring organization itself, which form is better—stock or mutual? Again, there is no definitive answer. New insurers are usually formed as stock companies because it is very difficult to form a mutual by persuading would-be policyowners to put up capital before the insurer can come into existence.

demutualization

On balance, the number of mutual insurers in the United States is decreasing due to mergers, insolvencies, and intentional shifting of mutual companies to the stock form of organization—a process called *demutualization*. Probably the most important reason for demutualization is to enable the insurer to raise capital quickly. A stock company, of course, can raise new capital by issuing stock, bonds, warrants, and other types of debt instruments, as well as by earning profits. Mutual insurers have only their profits and borrowings to provide additional capital for expansion, acquisition, or other purposes.

A second and often related reason for demutualization is to enable the insurance company to diversify its activities by merging with or acquiring other insurers or other types of financial institutions through the issuance or exchange of stock. Mutual insurers, having no stock, are less able to diversify in this way. Also, stock insurers can create upstream holding companies to facilitate diversification. Until recently, this avenue was not open to mutual insurers, and in many states it still is not available.

A third reason for demutualization is to facilitate payment of certain types of noncash compensation to the insurance company's key executives and board members. Compensation through tax-advantaged stock options and stock-ownership plans is not available in a mutual company, because it has no stock.

A fourth reason for demutualization is to gain federal income tax savings. The Internal Revenue Code, for example, limits the amount of dividends to policyowners that a mutual company may deduct for federal income tax purposes.

Reasons for Demutualizing

- Raise new capital
- Insurer diversification
- Noncash executive compensation
- Federal income tax savings

Nevertheless, the process of demutualization has certain significant disadvantages. The time, cost, and complexity may be enormous because of regulatory, tax, legal, and accounting requirements. Of particular importance is the regulatory requirement that the policyowners of the company seeking to demutualize be compensated adequately for loss of their ownership rights. A second disadvantage of demutualization is that, as a stock company, the insurer might become vulnerable to a hostile takeover. Third, as a stock insurer,

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the company would have to meet SEC and state rules relating to its equity securities. Fourth, demutualization represents a major change in corporate philosophy with the introduction of an explicit profit motive, a change that may be very difficult for senior executives and other long-standing employees of the former mutual company to accept.

mutual holding company

Several states allow mutual insurers to create a hybrid form of organization—the *mutual holding company*—to overcome some of the disadvantages of either remaining a mutual or demutualizing. The mutual holding company directly or indirectly controls a stock insurer. To be more specific, the mutual insurer creates a holding company controlled by the policyowners. The holding company then acquires at least 51 percent of the stock of a newly created stock insurance company that takes over the business of the former mutual insurer. The remaining stock can be sold to outsiders to raise additional capital for the new insurance company.

Other Types of Insuring Organizations

Most of the private insurance in the United States is written by stock companies and advance-premium mutual companies. Several other legal types of insurers also merit discussion.

fraternal insurer

Fraternal Insurers. A *fraternal insurer* is a special type of insurer providing insurance benefits, particularly life insurance, for its members. The operations of the fraternal insurer are closely related to and controlled by the bylaws of a lodge or a nonprofit social organization. Many fraternals are church oriented.[12]

reciprocal exchange

Reciprocal Exchanges. A *reciprocal exchange* is an unincorporated pool of funds owned by the policyholders and managed by an attorney-in-fact. The first reciprocal exchange was organized in 1888. At one time, in many states, reciprocals were not subject to most insurance regulation, but that distinction has now disappeared in most states. The two organizations, the pool and the manager, are now regulated as a licensed insurer.

In a reciprocal exchange's original and purest form, each policyholder was insured by all the others. In its now more popular, modified form, a reciprocal exchange may operate without individual accounts for its subscribers, and most are nonassessable. But though a reciprocal may appear to the layman to resemble a conventional mutual insurer, it is not. In a reciprocal exchange, the insured/insurer relationship is governed by a subscribers agreement or power of attorney in which policyholders assume liability as individuals and grant the attorney-in-fact the right to manage for a fee, as an insurer, the funds contributed by policyholders and others to the unincorporated association. A mutual, on the other hand, is a corporation owned by policyholders.

Reciprocal exchanges are few in number, but in certain areas and for personal lines of property and liability insurance, they have some significance.

12. The Association of America's Fraternal Benefit Societies maintains an information Web page at http://www.nfcanet.org.

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Although many are small, a few reciprocal exchanges have grown to a substantial size.

Captives. Captive insurance companies are hard to classify. As we suggested in chapter 2, captive insurers are sometimes considered a sophisticated form of self-insurance or retention. We mention captives again here because, like a mutual insurance company, a captive insurance company is an insurance company owned by the organization or organizations it insures. In that sense, a captive insurance company resembles a mutual insurance company.

A *single-parent captive* is such an example. A single-parent captive insurance company organized for the sole purpose of insuring the "parent" company that formed it. A *group captive*, also known as an *association captive*, provides insurance to a group of corporations (often members of a trade association) that also own the captive. A *risk retention group* is a special type of group captive formed under the Risk Retention Act of 1986. A risk retention group provides liability insurance subject to limited state regulation.

Until recently, businesses used captive insurers primarily to finance property and liability loss exposures. However, some companies have recently been able to expand their existing captive insurance programs to finance certain employee benefits. Because the Employee Retirement Income Security Act (ERISA) prohibits transactions between an employee benefit plan and the plan's sponsor, any organization that wants to insure its employee benefits through a captive must obtain a prohibited-transaction exemption from the U.S. Department of Labor (DOL). Among other things, it is necessary to demonstrate that employees will benefit from the proposed arrangement. In recent years, the DOL has expedited the process of approving applications, and many companies now see the captive approach as a viable option for covering certain employee benefit, such as post-retirement health care. Potential benefits include lower premiums and improved cash flow, especially for benefits with claims paid over an extended time period (such as long-term disability).[13]

Banks. In recent years, the entry of banks into the business of insurance has been characterized by a considerable amount of publicity, controversy, and legal jousting. However, one particular type of bank—the mutual savings bank—has been providing life insurance for many years in a few states.

Laws in these states authorize mutual savings banks to write life insurance on residents of the state and on persons regularly employed there. The amounts that may be issued are limited. Because the coverage is written without a commissioned agent as an intermediary, premium rates for savings bank life insurance usually compare favorably with those charged by other insurers. Nevertheless, the amount of savings bank life insurance represents only a

13. Sammer, Joanne, "The Captive Option for Employee Benefits," *Business Finance*, http://www.mag.com/magazine/archives/article.html?articleID=14501, accessed 9/12/06.

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small percentage of the total amount of life insurance sold in the three states. Perhaps this is attributable to the absence of an aggressive, commission-based sales force for savings bank life insurance.

The past few years have also seen the gradual entry of banks into other aspects of the insurance business, particularly in such lines as fixed and variable annuities, homeowners insurance, auto insurance, and life insurance. Initially, the majority of these banks created entirely new insurance operations from scratch. Later entrants to the field, however, have tended to form alliances with existing insurers and their insurance agencies, thus becoming, rather than insurers, marketing channels for insurance "manufactured" by others.

Blue Cross and Blue Shield plans

Health Associations. *Blue Cross and Blue Shield plans* are organizations formed for the purpose of prepaying subscribers' medical care benefits. Blue Cross plans provide coverage primarily for hospital expenses, while Blue Shield plans provide coverage primarily for physicians' services. Blue Cross and Blue Shield plans and health maintenance organizations (HMOs) play a particularly important role in the field of medical expense insurance. Detailed information about health maintenance organizations and other managed care organizations is contained in chapter 12. Chapter 3 summarizes the basic organizational characteristics of the "Blues."

Blue Cross organizations have historically provided hospital care in member hospitals on a service basis, rather than on a cash reimbursement basis. Blue Shield organizations have covered the costs of member physicians and surgeons, also on a service basis. Under the service-benefit concept, benefits are expressed in terms of the services that the hospitals or physicians who participate in the plan will provide, rather than in terms of dollar maximums. For example, a Blue Cross plan might provide hospitalization in semiprivate accommodations. In contrast, an insurance company might provide reimbursement for hospital charges subject to a dollar limitation, such as $600 per day.

While Blue Cross and Blue Shield plans have traditionally operated separately in limited geographic areas, most Blue Cross and Blue Shield plans in each area have now merged into a single entity. Blue Cross and Blue Shield plans must be members of the National Blue Cross and Blue Shield Association, which sets certain standards for the local organizations. Among these standards are requirements that the local organizations have boards of directors, the majority of whom are not health care providers, and that the organizations participate in national plans that offer portability of coverage and benefit availability for insureds outside their home service areas.

Although the Blues and insurance companies were once quite different, they have evolved over the years so that they now probably have more similarities than differences. The Blues tend to exist under special enabling legislation, which gives them some advantages, such as favorable state taxation, but also limits their underwriting and rating flexibility. The majority of plans are structured as not-for-profit organizations, making them similar to mutual insurance companies. Profits are not distributed to shareholders or

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policyowners, but some of the Blues have accumulated a rather substantial surplus despite their nonprofit status. However, several have converted to the traditional forms of stock or mutual companies.

Lloyd's associations

Lloyd's Associations. In contrast to stock and mutual insurers, which are corporations, *Lloyd's associations* are groups of individual insurers. Insurance written by Lloyd's associations accounts for only a small percentage of the total insurance sales in the United States. However, Lloyd's organizations are significant from a historical standpoint, and in the world market, they are very important for reinsurance and for insuring unusual and difficult risks.

Lloyd's of London, one of the most famous insurance institutions, bears the name of the coffeehouse where it originated more than 300 years ago as a center of shipping news and financial information. Lloyd's itself does not directly issue insurance policies; rather, insurance is written by underwriting members who sign "each for himself and not for another." The insurer, then, is not Lloyd's but the underwriters at Lloyd's.

There are a few American Lloyd's associations, including several in Texas. These associations write primarily fire and allied lines and auto physical damage insurance. In the American Lloyd's associations, each member is ordinarily liable for only a specified maximum, and the strict regulations of Lloyd's of London that govern membership, deposits, and audits are not present. Each American Lloyd's organization depends on the financial strength of its individual members within their limited liability. The American Lloyd's and the original London organization have no connection, and the American Lloyd's associations play a relatively small role in United States insurance.

THE MARKETING PROCESS

With this background of the types of organizations that provide insurance to individuals, households, and businesses, we now turn to the process by which organizations market their insurance. Why do financial planners need to understand how the insurance business markets its contracts and services? First, financial planners are in many cases active participants in the marketing process, deriving some of their compensation from being participants. Second, working with consumers of insurance, financial planners need to understand the choices among insurers and agents that clients must make in buying insurance. Finally, financial planners need to recognize that the methods companies use to sell and service insurance contracts are significant in determining their costs and usefulness.

Marketing the Insurance Product

Figure 3-1 shows the relationship of marketing to the product design, underwriting, and loss payment functions as insurance is distributed from

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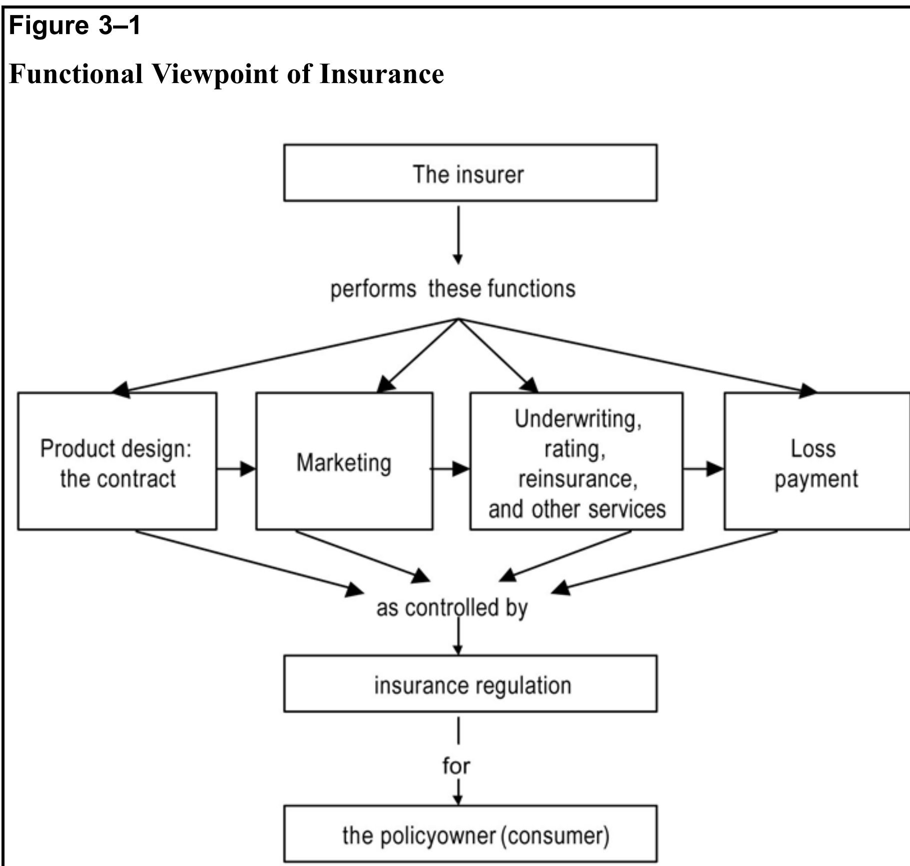
insurers to policyowners. The other functions and insurance regulation are described in later chapters.

Figure 3–1

Functional Viewpoint of Insurance



Marketing, or directing the flow of goods and services from the insurer to the consumer or user, is a particularly important business activity for insurance companies. The insurance product consists of a written legal contract plus a bundle of services. An insurer's representative may provide motivation, education, and advice both before and after an insurance policy is issued. In some ways at least, this bundle of services distinguishes insurance from tangible goods for which service often begins and ends with the sale.

The Insurance Market

A market is a meeting place where people transact business. Insurance practitioners use the term "market" in two different, almost opposite ways. On the one hand, "a market" refers to a geographic area or a group to whom a given type of insurance can be sold. For example, one might refer to the West Coast market or to the affluent market. Practitioners also use "a market" to refer to a source of insurance coverage. For example, the insurance companies that sell

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life insurance to people with a reduced life expectancy might be referred to as the substandard life market. As a verb, the term "market" can refer either to selling insurance to clients or to finding an insurer who will write the coverage a client needs. An insurance company will "market" insurance to the public; an insurance broker will "market" insurance to insurance companies on behalf of its clients.

To help clients facilitate effective insurance transactions, a financial planner must be familiar with the functions of the insurance market and the roles of the various participants in that market.

Types of Marketing Representatives

Many insurance buyers care more about the person with whom they deal than they do about the insurer that provides insurance coverage. A typical client is not especially concerned whether the insurer is organized as a stock insurer, a mutual insurer, or in some other form. Most are not aware what marketing system the insurer uses. Even if these distinctions seem unimportant to clients, financial planners need to distinguish among the types of insurer representatives with whom a client must deal. The applicant for insurance normally makes contact with the insurers through one or more of the following: (1) agents, (2) brokers, (3) insurance consultants and financial planners, and (4) service representatives.

Agents

agent

An insurance *agent* is often referred to as a producer because he or she produces business for the insurance company or companies that he or she represents. Legally, any agent represents a principal; an insurance agent's principal is an insurance company. Insurance companies appoint agents to solicit prospects for insurance, to negotiate with these prospects, and in some cases, to put contracts of insurance into effect. Agents are typically compensated by a commission that is a percentage of a policy premium.

The agent's powers are defined by his or her agency contract with the insurer. The agency contract spells out the agent's express authority. The agent also has implied or incidental authority to carry out those acts needed to exercise his or her express authority. An agent's acts may bind the principal even if those acts are outside the scope of the agent's express or implied authority, provided the acts are within the agent's apparent authority. Apparent authority arises when the agent, without contrary action by the principal, performs an act that appears to a reasonable person to be within the agent's express or implied authority. For example, if a life insurance agent waives a policy provision for a policyowner relating to the grace period for payment of renewal premiums, the insurance company might, if silent on the matter, be bound by the apparent authority of the agent. In an effort to prevent this from happening, insurers normally include a provision in their policies stating that

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only specified home office personnel have the authority to waive or modify a policy provision.

A principal may ratify an agent's actions that are outside the scope of the agent's authority and as a result be bound by those actions. For example, if an insurance contract states that renewal premiums must be sent to the insurer's home office, but the company routinely accepts premiums sent to its local agent, in the event of a dispute, the insurer would probably be found to have ratified the agent's collection of renewal premiums.

An agent owes the following legal duties to his or her principal:

- Exercise reasonable care.
- Obey the principal's instructions.
- Maintain accurate accounting records.
- Keep the principal informed.
- Comply with the agency contract.

The principal, in this case the insurance company, also owes certain duties to its agents:

- Pay for the agent's services.
- Maintain accurate accounting records.
- Reimburse the agent for expenses incurred as an agent.
- Reimburse the agent for liability incurred as an agent without the agent's fault.
- Comply with the agency contract.

Both the agent and the insurer are responsible for maintaining accounting records. The agent is responsible for properly handling any funds that belong to the insurer, such as premiums collected by the agent. The insurer, of course, is obligated to maintain accurate accounting records and to pay the agent commissions and, if applicable, other expenses provided for in the agency contract.

The liability that an agent may incur requires a comment. A customer who receives inappropriate advice, inadequate service, or incomplete coverage from an insurance agent who was allegedly negligent may bring a liability claim against that agent. These are referred to as errors and omissions claims. Insurance professionals and financial planners strive to serve their clients faithfully and avoid errors and omissions claims.

Errors and omissions can take many forms, and a detailed discussion is beyond the scope of this chapter. In discussing the principal-agent relationship, perhaps we should note that an error or omission on behalf of an agent sometimes obligates the insurer to pay a claim that should not have been covered. For example, the agent might bind coverage for which the agency contract does not provide binding authority. When the agent acted with apparent authority as an agent of the insurance company, the insurer will typically pay the claim and then seek reimbursement from the agent. Insurance agents, like other professionals, need to protect themselves against these and other claims with errors and omissions (E&O) professional liability insurance (discussed in more detail in chapter 19). Because E&O insurance usually

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includes a large deductible, even an agent who is insured faces a substantial loss in the event of an error or omission.

binder

Binding Authority. When coverage is bound, it is immediately put into effect. Written evidence that coverage is bound usually exists in the form of a written binder, but an oral binder is also valid. A *binder* is temporary evidence of insurance, and it is superseded when a written policy is issued.

Life insurance agents usually do not have binding authority, but property-liability insurance agents are normally authorized to bind insurance on behalf of the insurance companies they represent. A life insurance agent solicits life insurance applications. The agent usually collects the initial premium and gives the applicant a conditional premium receipt. The application must be approved by the insurance company before insurance becomes effective. If the applicant meets the insurer's normal underwriting standards, the insurance then becomes effective as of the date of the application or, in some cases, the date of the medical exam, whichever is later. A life insurance company issues the contract only after receiving the written, signed application and, often, a medical examination report. The agent has no authority to cover the insured immediately, and later contract modifications also require the insurance company's approval before they can become effective.

Property-liability insurance agents are usually granted binding authority, subject to any limitations set forth in the agency agreement—the contract between the agent and the insurance company. An oral or written binder is temporary evidence of insurance coverage until the insurance company issues the full insurance policy. When a client who has just purchased a car telephones an insurance agent to obtain coverage, an agent with binding authority can put coverage into effect immediately, before the client even drives the car home. A binder should identify the insurance company with which coverage is bound, any limits of insurance that apply, and the duration of the temporary coverage the binder provides.

Brokers

brokers

Brokers legally represent the policyowner rather than the insurer. Like agents, brokers can offer significant advice and counsel to their clients. The larger insurance brokerage firms are especially well equipped to handle the problems of insurance for a buyer with special requirements.

A broker is an independent contractor. The broker assists the applicant for insurance by finding coverage. A broker may be paid by the client, the insurer, or both. The duties of a broker are similar to those of an agent as described earlier, except that the broker's legal duties pertain more directly to the applicant or policyowner whom he or she represents.

Policyowners sometimes do not differentiate between an insurance broker and an agent. As explained above, an insurance agent is acting under specific and delegated authority from the insurer and is sometimes authorized to bind coverage within specific limits. A broker, on the other hand, has no

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such authority. Because a broker represents the applicant or policyowner, an applicant or policyowner is bound by the broker's acts. For example, any misrepresentation, mistake, breach of warranty, or fraud perpetrated by the broker on a policyowner's behalf makes the policyowner responsible as if the policyowner had committed the act. Furthermore, a statement by an applicant to a broker is not presumed to be known to an insurance company, whereas a statement by an applicant to an agent is presumed to be known by the company.

Some insurance agents are licensed as both agents and brokers. For example, a producer may act as an agent who commits the insurer for a part of a desired amount of coverage and as a broker in placing any excess coverage.

Example: Ripley is an agent for the XYZ Insurance Company, which specializes in preferred auto insurance. Ripley also has a broker's license that includes auto insurance. Ripley may have authority to bind coverage for an applicant in XYZ, but Ripley has no authority to bind coverage that he wishes to place with another insurer for which he acts a broker.

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surplus lines broker

A special type of broker, called a *surplus lines broker* (or excess lines broker), places coverage with nonadmitted insurers, who can often provide insurance when no other market is available in the state. For example, surplus lines brokers may place liability insurance for amusement parks and ski resorts, as well as many products liability coverages. A surplus lines broker often deals with the policyowner's broker rather than deal directly with the policyowner. Many states require surplus lines brokers to have a special license.

Insurance Consultants and Financial Planners

Financial planners, who help clients protect their income and assets, play a major role in the personal insurance marketing system. Financial planners are among the various other types of insurance and risk management consultants that may serve as intermediaries between insurance companies and their customers. Insurance consultants are usually compensated by the policyowner on a fee basis. Financial planners may be paid a fee by the policyowner, a commission from the insurer if they are also agents or brokers, or some combination of a fee and a commission.

Salaried Specialists

Many insurers, as well as some large insurance agencies, employ salaried service representatives to help agents sell or service the more complex lines of insurance. State insurance regulations usually do not require service representatives to be licensed.

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Life insurance service representatives include advanced underwriting specialists who aid the life insurance agent in estate planning and pension or tax planning. Salaried training specialists may recruit, supervise, and assist new life insurance agents. Most companies that write group life and health coverages have salaried company representatives who assist the life insurance agent with writing group contracts. Many property and liability insurance companies use marketing representatives to initiate agency contracts, help agents with special sales problems, and keep agents informed of the insurer's new contracts and services. Engineering, appraisal, and loss prevention services are often provided by company specialists in conjunction with local agents. In addition, company claims adjusters work in cooperation with agents on many losses involving large amounts or special problems.

Marketing Systems Used in Insurance

Agency versus Direct-Response Marketing Systems

The complex and intangible nature of insurance and its significance to the policyowner make personal contact through an intermediary essential to the sale of most insurance.

direct-response marketing

Direct-response marketing provides the exception to the general rule that insurance is sold through agents. Under a direct-response marketing system, the insurer deals directly with the applicant, without agents, through employees of the insurer. In specialized lines in certain market segments of insurance, these systems assume some importance. Dread disease insurers or hospital confinement indemnity health insurers who use direct mail or television advertising are common examples. All correspondence circulates directly between the company and the prospect, and the insurance contract is written and serviced by mail or telephone without an agent.

As another example of direct-response marketing, some insurers sell such coverages as annuities and life, health, auto, homeowners, and long-term care insurance over the Internet.

Mixed marketing systems are becoming increasingly common. For example, some insurance agencies market insurance through the Internet. Some insurance companies market through agents and also market directly to consumers through the Internet or through the mail. With group life and health insurance, it is increasingly common for salaried employees to assist commissioned agents.

Life Insurance Agency Systems

general agency system

Some life insurance companies use a *general agency system*. Historically, a general insurance agent was an individual entrepreneur granted a franchise by an insurer to market the insurer's products in a specified geographic area. The general agent represented only that one insurer and was responsible for

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hiring, training, motivating, and supervising agents. The general agent was compensated solely by commissions on business the agency produced and was fully responsible for all expenses of operating the agency. More recently, however, insurance companies typically provide some form of financial assistance to the general agent, perhaps paying some of the costs involved in hiring and training new agents and/or providing an allowance to cover some of the operating agency's expenses.

branch office system

In contrast with the general agency system, some life insurance companies use a *branch office system*, also referred to as a managerial system. Here, the insurer establishes branch offices in the areas where it writes business, with each branch headed by a manager who is a salaried employee of the insurance company. Again, the manager is responsible for hiring, training, motivating, and supervising agents for the company, but the insurer bears all costs of operating the branch. The branch manager may also receive a bonus as part of his or her compensation, depending on the quantity and quality of business the branch writes. Payment of bonuses to branch managers, together with coverage of some general agency operating expenses, has tended to blur somewhat the historical distinctions between these two agency systems.

personal producing general agent (PPGA)

A variation of the general agency system that has become significant for many life insurance companies is the *personal producing general agent (PPGA)* system. In this system, the insurer hires an experienced agent with a proven record of sales success as its general agent in a given territory. Unlike a traditional general agent, however, the personal producing general agent's main responsibility is his or her personal production. The PPGA is expected to sell the insurer's products, rather than to build an agency force for the company. The PPGA often receives higher commissions than other agents. The PPGA may be expected to meet certain sales quotas for the company but may also be allowed to represent other insurers.

Property and Liability Insurance Agency Systems

independent agency system

The two main agency systems that dominate in the property and liability field are the independent agency system and the exclusive agency system, sometimes referred to as the captive agent system. In the *independent agency system*, the insurance agency is an independent business organization that usually represents several insurance companies or groups of companies. The head of the agency pays all his or her own operating expenses and is compensated mainly through commissions on the business the agency writes. Some independent agencies are paid fees by the insurer for settling small claims or by the policyowner for providing risk management services.

The independent agent usually has some authority to bind the insurer for a client's coverage, to collect the initial premium and in some cases the renewal premiums, to submit the application to the insurer, and to deliver the policy to the policyowner. The policyowner is, by contract, the customer of the agent. The independent agent owns the policyowner's business and has a right to place it with a different insurer when the policy comes up for renewal, if the

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policyowner consents. Commission rates on property and liability insurance policies tend to be the same for renewal policies as for new policies. If renewal commissions were lower, an independent agent might be inclined to place the business with a different insurer at each renewal date to earn the higher first-year commission. Another result of ownership of the customer's business is that when the independent agent elects to retire or leave the business, he or she can sell the book of business to another agent. The insurer may not interfere with the agent's ownership rights.

One of the main advantages of the independent agency system is that the agent who represents several insurers can place business with the company that offers the best coverage at the best price for each applicant. One of the disadvantages is that a conflict of interest may exist when the agent has the opportunity to place business with any of several companies that pay different commission rates.

exclusive agency system

In the *exclusive agency system*, the agent usually represents only one company or group of affiliated companies. Compensation comes mainly from commissions on the sale of new business, with lower commission rates on renewals. One reason this is possible is that the insurance company tends to handle more of the service after the sale for exclusive agents (who are expected to devote most of their time to selling) than for independent agents (who tend to be more involved in client service). The insurer may cover some of the agent's operating expenses, particularly for new agents. The agency contract typically gives the agent either limited or no ownership, use, and control of policy and expiration data while the contract is in force. The agent has no control over what happens to the business when he or she retires or leaves the insurance field.

In the exclusive agency system, billing and collection of renewal premiums are almost always the insurer's responsibility, not the agent's. The agent may have the power, within limits, to bind the insurer on a client's coverage. The agent may also have the authority to settle small claims.

Although a clear distinction between independent agencies and exclusive agencies once existed, the lines today are blurring. Many exclusive agents have reportedly found ways to establish related independent agencies, often operated by a family member, or to participate in broker arrangements with independent agents.[14]

14. Barbara Bowers, "Easy Pass," *Best's Review*, March 2004, pp. 51-52.

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Main Agency Systems in Insurance

- Life insurance
  - General agent system
  - Branch office system
  - PPGA system
- Property/liability insurance
  - Independent agent system
  - Exclusive agent system

Group Insurance Systems

Marketing to consumers in the group insurance system is usually done through the employer. Payroll deductions are a convenient method of premium payment. Labor unions, credit unions, finance companies, professional associations, and other groups may also sponsor group insurance programs to lower insurance costs to the members of the group.

Group life insurance has been expanding since such plans began many years ago. Health insurance has used the group method of marketing even more extensively, especially in medical expense insurance. Annuities or insured pensions, too, have used the group system widely.

Group plans in property and liability insurance are much less common. Most of these plans have individual selection, rating, and contracts instead of group underwriting, master contracts, and certificates. However, employer participation is involved in the arrangements for the plans, premiums are collected through payroll deductions, and the objectives of the plans are similar to those of group life and health insurance. Auto and homeowners policies are the principal fields in which mass merchandising of quasi-group property and liability insurance has been tried.

SOURCES FOR FURTHER IN-DEPTH STUDY

- For detailed information on banks in insurance:
  - American Bankers Insurance Association, 1120 Connecticut Ave. NW, Washington, DC 20036. Phone 202-663-5163. Web site address aba.com.
  - Bank Insurance and Securities Association (ABIA), 303 W. Lancaster Ave., Suite 1C, Wayne, PA 19087. Phone 610-989-9047. Web site address bisanet.org.

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- For a thorough treatment of the subject of agency law, especially in life insurance, Graves, Edward E., and Christensen, Burke A. (editors), *McGill's Legal Aspects of Life Insurance*, 6th ed., chapter 16, Bryn Mawr, PA: The American College Press, 2008. Phone 888-263-7265. Web site address theamericancollege.edu.

CHAPTER REVIEW

Key Terms and Concepts

domestic insurer
foreign insurer
alien insurer
nonadmitted insurer
surplus lines insurance
stock insurance company
mutual insurance company
advance-premium mutuals
assessment mutuals
demutualization
mutual holding company
fraternal insurer
reciprocal exchange
Blue Cross and Blue Shield plans
Lloyd's associations
agent
binder
brokers
surplus lines broker
direct-response marketing
general agency system
branch office system
personal producing general agent (PPGA)
independent agency system
exclusive agency system

Review Questions

Review questions are based on the learning objectives in this chapter. Thus, a [3-3] at the end of a question means that the question is based on learning objective 3-3. If there are multiple objectives, they are all listed.

3-1. What are the features of stock and mutual insurance companies as to form of business, ownership, voters for the board of directors, and recipients of dividends? [3-2]

3-2. In recent years, numerous mutual insurance companies have shifted to a stock form of organization through the process of demutualization.
a. Why do companies demutualize? [3-3]
b. What are the potential disadvantages associated with demutualizing? [3-3]

3-3. How do reciprocal exchanges differ from mutual insurance? [3-1]

3-4. With regard to Lloyd's of London, who provides the insurance (that is, who is the insurer)? [3-1]

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3-5. After you discuss an insurance policy available from a mutual insurance company, your client, Sara Lott, asks whether mutual insurance companies always provide lower-priced coverage because they do not need to earn a profit for stockholders. How would you respond? [3-2]

3-6. Why does a financial planner need to understand how the insurance business markets its contracts and services? [3-4]

3-7. What are the three powers held by an agent and the legal duties an agent and principal owe each other? [3-6]

3-8. Is binding authority generally given to each of the following by their insurers?
a. life insurance agents [3-5]
b. property-liability insurance agents [3-5]

3-9. At the advice of his financial planner, Tom Johnson meets with an agent at an all-lines agency to discuss obtaining coverage to meet his various protection needs. In each of the following cases, indicate whether or not Tom has coverage immediately and why.
a. After gathering information about Tom's new home and its contents, the agent recommends a homeowners policy with XYZ Insurance Company. After getting satisfactory answers to questions regarding price and the claims service offered by the company, Tom tells the agent he wants the policy from XYZ. The agent tells Tom he's covered. [3-5]
b. After gathering information about the needs of Tom's family in the event of his death and about Tom's existing group life coverage at work, the agent recommends a $500,000 variable universal life policy from ABC Life to meet Tom's additional needs. The agent points out the flexibility of the policy both in terms of premium payments and investment choices. Tom fills out the application and gives the agent the minimum first premium. The agent tells Tom, "You're going to like the flexibility and performance of your new policy." [3-5]

3-10. What is the difference between insurance agents and brokers in terms of
a. whom they represent? [3-5]
b. their power to bind the insurance company? [3-5]

3-11. What are the key features of the following agency systems used to market life insurance?
a. general agent [3-5]
b. branch office or managerial system [3-5]
c. personal producing general agent (PPGA) [3-5]

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3-12. What are the key features of the two main agency systems-the independent agency system and the exclusive agency system-used to market property-liability insurance?
a. How many companies or groups of companies does a producer represent? [3-5]
b. Who pays operating expenses? [3-5]
c. What is the relative size of renewal versus initial commissions? [3-5]
d. Who generally has ownership, use, and control of policy and expiration data? [3-5]
e. Who generally collects premiums and settles claims? [3-5]

3-13. Your client, Bill Jones, asks your advice as a financial planner about whether it is better to purchase homeowners insurance from an independent insurance agency, which represents several insurers, or an exclusive agent, who represents only one insurance company. How would you respond? [3-7]

3-14. Mark and Liz Olson have individual life insurance policies issued by a mutual insurance company that has its corporate headquarters in their state, a homeowners policy issued by a stock insurance company based in another state, and an auto insurance policy issued by a reciprocal exchange. They also have medical expense protection through a Blue Cross/Blue Shield plan provided by their employer. Last year when their auto insurance premium increased, they decided to do some comparison shopping and were surprised to discover that some insurance agents represent may different companies while others represent only one insurance company.
a. What different types of insurers are the Olsons dealing with? [3-1, 3-7]
b. What different types of marketing representatives are the Olsons dealing with? [3-1, 3-5]

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