IT'S ALL ABOUT RISK

THE HIGH-STAKES WORLD OF COMMERCIAL INSURANCE

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FOREWORD

Commercial insurance is an integral part of the society it serves. It is both a product and a service, in constant flux as it changes and evolves to meet the needs of a fluid society. Every business needs it—from oil rigs to rock concerts, across the street or across the globe. Insurance, by necessity, is adaptable and responsive.

But recent changes in the industry and the society it serves have made this fluidity even more dramatic. The technology revolution is rapidly changing the insurance business world to one that is virtual, with buyers engaging in e-commerce on all levels. Globalization, which has transformed the landscape of American commerce from a local and regional focus to a worldwide perspective, has in turn made insurance a global marketplace. An unprecedented boom of mergers and acquisitions among all segments of the insurance industry is creating a world where former competitors find themselves on the same team. And changes to federal law allowing liaisons between insurance and other financial service industries have opened new opportunities for industry and consumers alike.

The insurance industry has been shaped by many unprecedented forces in the past 20 years—mega-catastrophes like 9/11 and Hurricanes Andrew and Katrina, global economic convergence and sweeping legislative and regulatory changes, to name just a few. Things continue to change so quickly that it's difficult to predict where the business of commercial insurance will be in a year, in six months, or even next week. Will consolidation and convergence continue, mirroring other industries, until there are just a few large players that dominate the industry? Will the steady growth of e-commerce and alternative risk management mechanisms eliminate the insurance industry as we have known it and create something entirely new? What opportunities will be open to insurance buyers as global economic interdependence continues to grow? What is the most efficient way to regulate the new entities resulting from all these changes we call "modernization?" How will these changes affect pricing, service and availability?

As the representative of the world's most successful agencies and brokerages, The Council of Insurance Agents & Brokers is in a unique position to address these issues. Our members design and deliver insurance and risk management services to protect the assets of businesses, organizations, governments and individuals throughout the United States and around the world. We understand both business and insurance.

But even with this expertise, it is difficult for us to make clear predictions about what the future holds for the commercial insurance industry. Twenty years ago, insurance industry sages were still operating under the principle of market cycles in which pricing and availability ebbed and flowed every few years. None of the experts of the mid-1980s would have predicted that 20 years later, the insurance industry would be operating in a "soft cycle" typified by intense competition for market share, low pricing and excess capacity among companies.

However, despite all the changes, one thing remains constant: businesses need insurance to operate, protect their assets and employees, promote research and development to bring new innovative products to the market and ensure their—and our—economic future. Buyers use risk management—the process of identifying risk, evaluating it and taking steps to minimize it—and insurance as the principal method for protecting financial assets. Commercial insurance agents and brokers are the experts who help these businesses determine their risk profile and pinpoint the most effective ways to address it.

Commercial insurance agents and brokers are the key link in the risk management process between insurers and the insurance consumer. Far from being mere middlemen, they are problem solvers, consultants, insurance marketplace experts and innovators. They have the skills and industry knowledge necessary to design insurance programs that will help protect the financial and physical assets of businesses, organizations, governments and individuals. No matter how much the industry may change, agents and brokers will remain an integral part of the equation.◆

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I. THE BUSINESS OF INSURANCE

WHAT IS INSURANCE?

Insurance is a financial product that legally binds the insurance company to pay losses of the policyholder when a specific event covered by the policy occurs. Simply put, the policyholder passes on risk of loss to the insurer for a fee, known as the premium.

The insurer, in turn, may pass on some of that risk to other insurers or reinsurers. This makes possible ventures that would otherwise be prohibitively expensive if one party had to absorb all the risk. Advancements in medicine, product development, space exploration and technology all have become a reality because of insurance.

WHEN WAS INSURANCE FIRST SOLD?

The insurance industry has ancient roots. The Chinese used the principle of spreading risks to protect goods shipped to market. We also know the Phoenicians used it in trading. In fact, much of the early insurance activity centered on shipping and trading. It is believed that the first insurance policies were developed by brokers in the 1300s in what is now Northern Italy.

The origins of the modern insurance business are thought to have generated from a small London coffeehouse owned by Edward Lloyd in the late 17th century. From the modest ventures of Lloyd and his friends blossomed what is today Lloyd's of London. In 1752, Benjamin Franklin formed The Philadelphia Contributorship for the Insurance of Houses from Loss by Fire, which has become the oldest continually operating insurer in the United States.

The basic principles of insurance have not substantially changed since the 17th century. The idea is to spread risk so no one party must cope with a devastating loss.

WHO BUYS INSURANCE—AND WHY?

Businesses, governments, non-profit institutions and everyday citizens rely on insurance products to protect them from financial loss.

Consumers buy automobile insurance to cover both their cars and people who may be injured in an accident. Homeowners and renters buy insurance policies to protect their property and protect themselves from liability. Many consumers buy life insurance to protect their families in the event of untimely death.

Businesses purchase insurance to protect the buildings in which they are located and the contents of that property. They also purchase insurance to protect themselves against various types of lawsuits.

In some instances, the federal government requires individuals and businesses to purchase insurance. Known as financial responsibility requirements, government-mandated purchase of insurance is intended to ensure that injured parties will be compensated. Mandatory purchase of automobile insurance is an example of a financial responsibility law aimed at individuals. An example of a financial responsibility law aimed at corporations is the mandatory purchase of workers' compensation insurance to protect employees who are injured while on the job.

Businesses may also require other entities to buy insurance. For instance, a retailer may require its suppliers to carry product liability insurance. Similarly, most hospitals require doctors to carry medical malpractice insurance, and mortgage firms require their clients to insure the properties used as collateral.

WHAT TYPES OF INSURANCE PRODUCTS ARE AVAILABLE?

There are many types of property/casualty insurance products available to both businesses and individuals. Personal lines insurance, such as homeowners, auto, life and health insurance, protects individuals.

Businesses purchase insurance policies covering all aspects of commerce—losses for damage to property or merchandise, liability for injury or property damage to others, workplace injuries and illness, fraud, and business interruption. Government entities buy insurance to cover services such as bus and subway systems. Non-profit organizations such as the Boy Scouts or the Red Cross also carry commercial insurance coverage. Insurance coverage for businesses can be quite complex and involve several different types of policies. For example, an average hospital will require 142 different policies to address all the risks it faces, from liability for medical errors to coverage of the physical hospital property to workers' compensation for the hospital staff. It is the job of an agent or broker who specializes in working with hospitals to ensure that all of the potential risks are addressed.

Here is a listing of some typical business coverages:

- **Property:** Insurance to cover the financial consequences of accidental damage to property caused by events such as fire, crime and transportation accidents.
- **General Liability (also known as Casualty):** Insurance that covers injuries sustained by a third party claimant—someone who suffered physical or economic harm attributable to the insured. Liability coverage can include auto, personal, products liability and professional malpractice. Because liability losses involve a third party, a finding of fault or responsibility must be made. The courts are often called upon to decide who is responsible and what compensation should be made.

- **Workers' Compensation:** Insurance that reimburses workers for job-related injuries regardless of fault and generally eliminates the employee's right to sue the employer.
- **Business Interruption:** Insurance that reimburses an employer for loss of net income as a result of a covered loss, such as a fire or other catastrophic event.
- **Employment Practices Liability (EPL):** Insurance that protects the employer against lawsuits arising from sexual harassment, discrimination and other charges.
- **Directors and Officers (D&O):** Insurance protecting the officers of a company against personal and professional lawsuits arising from their duties and actions on behalf of the company.

Many specialized types of coverage have evolved to address emerging risks, such as cyber crime and data security breaches. Some policies also respond to new types of coverage that consumers want to buy, such as the ability to rebuild a property as a "green" building after a loss. While the possibilities for coverage are wide-ranging, there are some limitations. For example, insurers will not provide coverage for deliberate illegal or criminal acts.

Additionally, there are some risks that mainstream insurers are unwilling to underwrite because the activity performed by the business is extremely hazardous or unusual or the possibility of loss is very high. These risks will often find the coverage they need in the surplus lines market. The surplus lines market operates under different regulatory standards than the mainstream insurance market. A further discussion of surplus lines can be found in Chapter II.

WHAT ABOUT EMPLOYEE BENEFITS?

For employers, the ability to offer benefits to their workers has become an increasingly important part of attracting and keeping qualified employees and an increasingly important part of their insurance needs. A skilled insurance broker/consultant can help guide a business through the changing maze of employee benefit and pension issues.

Most employee benefits are written on a "group" basis, which means that the employer holds a master policy under which all employees are covered. Because the "group" has many participants, the policy can often provide the coverage sought at a lower rate than if each employee purchased a policy individually.

Below are some examples of employer-sponsored insurance plans:

- **Group Health:** Insurance to assist employees in paying for health care expenses such as doctors visits, hospitalization and prescription drugs. Group health insurance began as an indemnity product in which individuals were reimbursed for the full cost of their medical expenses. As health care costs have risen, group health has moved toward a system where employees pay for a portion of medical expenses through deductibles and co-payments, and the health insurer pays the balance. Group health also has increasingly moved toward a "managed care" environment, where employees' reimbursement for medical expenses varies based on whether they use medical providers who have agreements with health care companies, like health maintenance organizations (HMOs) and preferred provider organizations (PPOs). Another alternative that has been gaining popularity with employers is consumer-driven health care. Consumer-driven health care permits individuals to use a tax-free Health Savings Account to pay for routine medical expenses, while providing coverage for catastrophic health expenses through a health insurance policy with a high deductible.

- **Group Life:** Insurance that will provide a death benefit for the covered employee. Most employers offer a pre-set level of coverage to their employees, such as one year's salary, and provide an option for the employee to purchase additional coverage at a reduced cost.
- **Group Disability:** Insurance to provide individuals with partial income should they suffer a non-work related illness or injury. Again, employers generally provide a base benefit and offer employees the ability to purchase additional coverage.
- **Group Long-term Care:** Insurance to provide individuals with the ability to pay for expenses associated with disabilities or chronic illness, including assisted living facilities or nursing care. Most employers do not yet offer this as a standard benefit; rather, they offer employees an opportunity to purchase the coverage through the "group."

Retirement programs are the other half of the benefits picture. These programs can be divided into two main categories, employer-sponsored pensions and employer-sponsored savings plans such as 401(k)s and 403(b)s.

An employer-sponsored pension is a benefit plan where the employer contributes money to a fund that will provide the employee with income in retirement. There are two types of pensions. The first is a "defined benefit" plan, in which the employee will received a specified monthly amount after retirement, usually based on the worker's final average pay. The second is a "defined contribution" plan, in which the employer contributes a specified amount to the employee's pensions plan periodically, usually quarterly, semi-annually or annually. Defined benefit plans are becoming much less common and are being replaced by defined contribution plans. An employer-sponsored savings plan is a benefit plan that permits the employee to save a certain percentage of income before taxes are deducted. The savings can grow in a tax-deferred environment until the employee begins to withdraw money at retirement. Individuals normally may not withdraw money from such a plan until they reach age 59.5. These plans take two general forms: a 401(k), which is used by most private sector employees, and a 403(b), which is used by certain employees of public education organizations, certain tax-exempt organizations and self-employed ministers. Both 401(k)s and 403(b)s operate in a similar fashion.

Many employers will match up to a specified percentage of an employee's income. For example, an employee may choose to put 6 percent of income into a 401(k). The employer may offer a "match" of 5 percent of income. This means the employee is saving a total of 11 percent of their income annually.

HOW IS INSURANCE DISTRIBUTED?

The vast majority of insurance is distributed through agents and brokers. Some insurance companies, such as GEICO and USAA, are known as "direct writers" and sell directly to policyholders. Agents who represent only one insurance company, such as those who sell for State Farm, Allstate or Nationwide, are known as exclusive or captive agents. These two distribution systems operate mainly in the market for individual property/casualty policies, with some sales to small businesses.

Nearly all commercial insurance is sold by independent agents or insurance brokers. Independent agents represent more than one insurer. Insurance brokers generally do not represent insurers but rather represent the individuals or companies buying insurance policies. Commercial agents and brokers have broad knowledge of the insurance marketplace as well as expertise in alternative coverage mechanisms for protecting their clients against all kinds of risks. They consult with clients to devise broad risk management strategies and will work with several companies to design an insurance coverage program that meets their clients' needs. A more detailed discussion of agents and brokers may be found in Chapter III.

HOW BIG IS THE U.S. INSURANCE INDUSTRY?

The insurance industry is an important source of employment in the United States, generating more than 2.3 million jobs. There are more than 2,600 property/casualty insurance companies and more than 1,200 life/health insurance companies in the United States[1]. U.S. insurance premiums totaled more than $1.032 trillion in 2006.[2] Premiums in the property/casualty area totaled $448.9 billion, while life and health premiums totaled $583.6 billion.[3]

World insurance premium volume totaled more than $4 trillion in 2007[4], with the United States accounting for about 30 percent of the total market share. Japan's share of the world market was 16 percent, followed by the United Kingdom at 14 percent, France at 8 percent and Germany at 4 percent.[5]

However, the global business of insurance is changing rapidly. Twenty years ago, insurance was still a local and regional business, with relatively few agencies and brokerages conducting business overseas. In recent years, more American businesses are taking advantage of the worldwide marketplace, and global insurance is no longer the exclusive domain of large multinational brokers. We're living in a world where political borders are increasingly blurred. Commerce is conducted not only across the street but also around the globe, and commercial agents and brokers have evolved to assist their clients in obtaining the appropriate coverage for the risks they encounter both here and abroad.◆

1 Insurance Information Institute 2008 Fact Book
2 Insurance Information Institute 2008 Fact Book
3 Insurance Information Institute 2008 Fact Book
4 Swiss Re Sigma study—World insurance in 2007: Emerging markets leading the way
5 Swiss Re Sigma study—World insurance in 2006: Premiums came back to "life"

II. THE MANAGEMENT OF RISK

WHAT IS RISK MANAGEMENT?

Risk management is the process of analyzing possible exposure to loss, reducing loss potential, and protecting financial assets. Not all risks must be accepted as they are. Some can be avoided; others can be modified to limit their frequency or financial consequences. When properly managed, most risk can be controlled and minimized.

Risk management is comprised of several components: identifying the physical and financial risks facing a company; developing solutions to prevent or mitigate the impact of a particular risk; developing a means to protect against those risks that cannot be mitigated; and monitoring and refining the risk mitigation programs. Some large organizations employ an individual or group of individuals to perform the risk management function.

Commercial agents and brokers also act as consultants on risk management and advise them on the best ways to mitigate risk. For example, a commercial agent or broker may have a professional baseball team as a client. In many cases, the team will also own the stadium in which it plays. The agent or broker will work with the team's owner to develop a risk management program to address the possible losses including the risks facing the players on the team, such as injuries on the playing field; to address risks related to the stadium, such as damage from a fire; and risks related to the people attending events at the stadium, such as injury from a foul ball.

There are many ways to protect financial assets. Purchase of insurance is the traditional way to transfer risk, but there are other methods, known generally as alternative risk management.

WHY ARE ALTERNATIVE RISK MECHANISMS POPULAR?

Alternative risk mechanisms became popular during the insurance liability crisis of the mid-1980s, when pricing and availability of many traditional lines of insurance became problematic. While insurance generally has become more available and affordable since then, buyers still seek out these options, mainly because they put more control in the hands of the insurance buyer. Predicting future availability and affordability of insurance has become much more difficult, and alternative risk mechanisms may become more important in coming years. Events like 9/11 and Hurricane Katrina have caused some of the largest insured losses in history. These events have changed the way that both insurers and businesses approach risk management, in addition to affecting the way in which insurers deploy their capital in underwriting risks. That in turn led to increased volatility in insurance markets.

These trends point to the fact that risk management involves far more complexity than the simple purchase of insurance. A big part of the picture is preventing risk in the first place. Insurance agents and brokers are skilled in the art of working with their corporate clients, not only to place coverage where appropriate, but also to set up safety programs and employ other risk mitigation techniques.

WHAT ARE SOME POPULAR METHODS OF ALTERNATIVE RISK MANAGEMENT?

Self Insurance: Self insurance can take many forms. Policyholders can assume higher deductibles or accept lower amounts of insurance coverage for certain risks. However, any self-insurance program must be carefully balanced with a well-managed loss control program to minimize the exposure a business faces and to protect third parties that are injured. That's where skilled commercial agents and brokers come in. They can assist their clients in developing sound loss control programs.

Captives: A captive insurer is an insurance company that is wholly owned by a non-insurance organization, typically a large company or group of companies in the same business. Its primary purpose is to insure or reinsure the risks of the parent organization, but captives also can cover risks of non-related parties. Creating a captive insurance company is a popular risk-financing alternative, especially when insurance costs are high. Captives also are a popular option for buyers who want to personally finance and control their risks. Captives once covered property and casualty risks exclusively; now some corporations use captives to insure employee benefit programs such as group life and group disability.

A well-run captive can provide insurance coverage at rates that are generally lower than those available in the traditional insurance marketplace. Captives rely on reinsurance to spread the risk, just as traditional underwriters do. Many captives used to be located outside the United States to avoid the costs, time delays and other problems related to a state-based system of regulation. However, in recent years, several states have modernized their insurance laws to permit and encourage the formation of captives, making the United States the largest captive domicile in 2006 with 25 percent of the world's captive insurers situated in this country. Bermuda, for years the leading captive domicile, is now a close second with 20 percent of the world's captives.[6]

6 Insurance Information Institute website

Risk Retention/Purchasing Groups: The Liability Risk Retention Act of 1986 provided for the creation of risk retention groups and risk purchasing groups to assist insurance buyers with finding liability coverage. Risk retention groups (RRGs) allow insurance buyers to form groups to insure their own liability risks. RRGs must be chartered and licensed as liability insurers in at least one state, but they may contract business in multiple jurisdictions. RRGs are exempt from most state insurance laws. Similarly, risk purchasing groups (RPGs) permit insurance buyers with similar liability risk profiles to join together to purchase insurance coverage.

Surplus Lines Insurance: There are certain risks that the mainstream insurance market will not underwrite because they are unusual (such as professional liability), very hazardous (such as an explosives factory), or have the potential of high losses. These types of risks can generally find coverage with surplus lines insurers, which are also known as the non-admitted market. Surplus lines insurers need not be licensed in every state in which they conduct business (hence they are "not admitted" to do business there); however, they must be licensed in their state or country of domicile. They generally must meet certain eligibility standards and receive approval to do business in each state. Surplus lines insurers do not need to comply with state rate and form filing laws but are subject to other state laws, such as those governing solvency.

In order for a consumer or business to seek coverage from a surplus lines insurer, the consumer/business must provide certification that it has failed to find coverage in the mainstream market. Once this certification has been provided, the consumer/business will work with an insurance broker who specializes in surplus lines placements (a surplus lines broker) to secure the desired coverage. In some cases, commercial insurance agents and brokers work with surplus lines brokers to find specialized coverage for their clients; these surplus lines brokers are known are known as "wholesalers."

Capital Markets: By using investment banking tools, insurers have new options to manage risk and financial assets. In recent years, the capital markets have been increasingly attracted to insurance and reinsurance. One of the reasons that capital markets are looking more to the insurance and reinsurance sectors is that they provide an investment environment that is not correlated to other financial investments like stocks. This is especially true of the protection offered by reinsurance. Today, for instance, a primary insurer may float a catastrophe bond offer instead of buying reinsurance.

A catastrophe bond works in much the same way that other types of bonds do. An insurer or reinsurer will look to cover a loss from a specified event (such as an earthquake in Tokyo) in the capital markets. Investors will subscribe to shares in the bond offering. If the specified event does not occur, the investor will receive a return based on the principal invested plus a premium for the risk assumed. If the specified event does occur, then the funds invested in the bond are used to pay claims from the event. This method of risk management is becoming increasingly popular in dealing with natural catastrophe risks.

Capital markets also can provide the funding for insurers to begin business. For example, after Hurricane Katrina, several new insurers and reinsurers were established to insure natural catastrophe risks. Similarly, after 9/11, several new insurers and reinsurers were established. These entities were founded to provide new capacity in the private insurance markets and were funded by the capital markets—private equity firms and hedge funds, to name a few—that saw a new opportunity for investments not directly correlated with other financial markets. This investment has helped to increase market capacity, which means that insurers have additional capital that they may then deploy to increase the overall amount of insurance coverage that they are willing to write.◆

III. REINSURANCE

WHAT IS REINSURANCE?

Reinsurance is based on the same principle as insurance—the sharing of risk. Just as businesses and individuals buy insurance to limit their risk exposure, insurance companies reinsure a portion of their own risks. An underwriter with reinsurance does not have to pay all the costs of a large or catastrophic loss. The underwriter shares premiums and losses with others. In short, reinsurance is insurance for insurance companies.

Reinsurance is typically used by primary insurers to cover unforeseen or extraordinary losses. This is especially true of natural and manmade catastrophes and so-called "long-tail" risks like pollution liability, where losses may not be evident until years after the event resulted in the pollution. Primary insurers also use reinsurance to limit liability on certain risks, increase their capacity to write business and assist in stabilizing their businesses by leveling wide variances in profit and loss margins.

An underwriter's ability to spread risk affects insurance capacity. When reinsurance capacity is limited, the overall capacity in the insurance marketplace declines. This is especially true of capacity in the commercial property/casualty lines of insurance because insurers reinsure a significant portion of this business.

There are two kinds of reinsurance: facultative and treaty. Facultative reinsurance covers a single policy or risk. For instance, an insurer may be willing to assume only part of a specific risk and will look for a reinsurer to accept the balance of the risk in exchange for part of the premium. The reinsurer may set the terms and conditions under which it will agree to the reinsurance transaction.

Under treaty reinsurance, an insurer and a reinsurer sign a contract under which the reinsurer agrees to accept a predetermined amount of losses generated by a class or "book" of business written by the insurer. The predetermined amount that the reinsurer will cover can be a percentage of the losses, a specified dollar amount or a combination of the two. The reinsurer accepts the terms and conditions placed on the underlying insurance policies and will generally pay after insurer losses reach the deductible amount.

HOW DOES THE REINSURANCE BUSINESS OPERATE?

Some reinsurance is purchased by the primary insurer directly from the reinsurer, just as some insurance is purchased directly from a carrier. However, the majority of reinsurance is placed by reinsurance brokers who operate in a manner similar to commercial insurance brokers, except that their clients are insurance companies rather than organizations. Many of the largest U.S. commercial property/casualty brokers also have reinsurance brokerage subsidiaries.

An insurer's ability to underwrite risks—and ultimately the overall capacity of the insurance marketplace and the cost of coverage—is directly affected by reinsurance. If an insurer cannot spread risk through reinsurance, it is limited in the number and size of the risks it can insure.

The risk-spreading cycle continues once the reinsurer agrees to share a risk with an insurer. Reinsurers also purchase reinsurance, though at this level the transaction is called a retrocession. Ultimately, the responsibility for paying a claim —particularly a large one—may be shared by the global insurance industry.

It is important to recognize that reinsurance is a business transaction between an insurance company and its reinsurers, two parties both highly knowledgeable about the subject at hand. An insurer pays valid claims for losses covered by policies it underwrites. In turn, the insurer files a claim with its reinsurers for reimbursement of the share of the risk they hold. If there are disputes about the amount to be paid or the contract terms, the insurer and reinsurer generally pursue arbitration of the dispute before turning to legal action.

WHERE ARE THE REINSURANCE MARKETS?

Reinsurance is a global business. The percentage of U.S. business that ends up overseas varies, but with a large risk it is necessary to move some of the reinsurance offshore. In 2007, net premiums written by offshore reinsurers exceeded $58 billion. This accounts for about 53 percent of the U.S. market.[7]

WHO REGULATES THE REINSURANCE INDUSTRY?

Because reinsurance involves spreading risks around the globe, and because of the sophisticated nature of the parties to the reinsurance contract, reinsurance regulation differs markedly from regulation of primary insurers and agents and brokers. In the United States, authority to regulate reinsurance rests with state insurance departments, which focus primarily on solvency. State regulators generally do not dictate the reinsurance policy form or premium rates as they do for primary insurers.◆

7 RAA Offshore Reinsurance in the U.S. Market: 2007

IV. THE ROLE OF THE COMMERCIAL AGENT AND BROKER

WHO ARE INSURANCE AGENTS AND BROKERS?

Insurance agents and brokers serve as intermediaries between an individual consumer or organization and an insurer, and they currently must receive a license from each state in which they wish to conduct business. Insurance agents represent insurers and generally have agreements with each insurer defining the scope of that agent's authority to represent the insurer. Insurance brokers represent the insurance purchaser and also may have a written agreement with the purchaser. Commercial insurance agents and brokers generally have access to a wide range of insurance companies so that they can design an insurance program that best meets their clients' needs. There has been a trend over the past 10 years, spurred in part by the federal Gramm-Leach-Bliley Act of 1999, to move toward a single producer license that bases the need for licensure on the activity performed by the individual—that is, selling, soliciting or negotiating insurance. A producer license permits an intermediary to act as either an agent or a broker, depending upon the transaction.

Commercial agents' and brokers' broad knowledge of and access to the worldwide insurance marketplace permits the selection of the insurance products or risk management systems that are best suited to the buyer's needs. Commercial insurance agents and brokers are an important link in the risk management chain.

Commercial insurance agents and brokers bring a unique perspective to the industry. By their very nature, commercial agents and brokers are insurance market innovators and experienced consultants for their corporate clients. While supportive of the traditional insurance system, they also encourage the development of alternative risk management products and have been instrumental in working with insurance companies to develop new insurance coverages that meet their clients' ever-evolving needs. This gives insurance buyers options for high quality, affordable methods of protecting their business assets.

Traditionally, agents and brokers help their clients find coverage in the primary insurance market. In reality, commercial agents and brokers are far more than simple middlemen. With expertise in the businesses of their corporate clients, commercial agents and brokers are consultants and advisers. They don't simply place insurance coverage with a carrier. Rather, they advise their clients on ways to ameliorate loss within their businesses, help them set up alternative risk mechanisms such as offshore captives for cost efficiency and assist in negotiating the best coverage for a risk. The commercial insurance agency and brokerage business operates on a multinational level, serving clients around the world. The 100 largest U.S. insurance intermediaries generated $21.39 billion in revenues in 2007, a 3.5 percent increase from $20.66 billion in 2006.[8]

HOW ARE AGENTS AND BROKERS REGULATED?

Agents and brokers are licensed and regulated by the states; they must be licensed in each state where they conduct business. Because each state maintains its own set of rules and regulations regarding licensing, agents and brokers historically have had to navigate a system with widely varying requirements to conduct business regionally or nationally. This is an expensive and inefficient system. While the 1999 Gramm-Leach-Bliley Act included a provision to streamline and standardize the licensing process by providing for reciprocity in agent and broker licensing, it is not clear that the necessary state statutory changes have been followed. Please see Chapter V for additional details.

HOW IS THE ROLE OF COMMERCIAL AGENTS AND BROKERS CHANGING?

In today's fast-paced and complex world, more people need insurance to cover changing and expanding risk exposures. Spreading risk has taken on global significance. Commercial insurance companies, agents and brokers must be able to deliver increasingly sophisticated products and services faster and better. However, like politics, insurance remains a local business at heart. The key to successful loss control lies in the relationship between agents, brokers and their clients.

The pace of consolidation among agencies and brokerages in recent years has made agents and brokers more competitive than ever. Demanding corporate clients want more from their agents and brokers in terms of professionalism and global know-how. Technology is changing the broker's role even further.◆

8 Business Insurance, July 16, 2007

V. GOVERNMENT REGULATION AND THE INSURANCE INDUSTRY

HOW IS THE U.S. INSURANCE INDUSTRY REGULATED?

Insurance is the only major financial services industry that is not federally regulated. The current state insurance regulatory system dates back to 1851, when New Hampshire formed the first state agency charged with regulating insurance. Other states followed. The National Association of Insurance Commissioners (NAIC), a trade association representing chief insurance regulators from across the country, supports the state insurance regulatory system although the NAIC itself has no direct regulatory authority.

In 1945, Congress passed the McCarran-Ferguson Act, which generally entrusted the states with primary responsibility for insurance regulation. McCarran-Ferguson also exempts the industry from federal antitrust and fair trade laws so long as the states fill the regulatory gap. However, there are certain areas of the insurance business that come under federal regulation.

HOW DO THE STATES REGULATE THE INSURANCE INDUSTRY?

The states are responsible for the supervision of all the players in the insurance industry, including insurers, reinsurers, agents and brokers.

Ensuring solvency of insurers and reinsurers is the regulators' primary and most important regulatory function. An insurance contract is a promise to pay the policyholder in the event of a loss—and that promise means very little if the insurer does not have the money available to pay the claim. State insurance regulators perform periodic financial examinations of an insurer's finances to verify that the insurer is solvent; that is, to ensure that the insurer has a sufficient amount of capital and reserves necessary to pay policyholder claims.

In addition to monitoring the solvency of insurers, state insurance regulators also monitor their conduct in the marketplace. Some examples of this type of regulation would be approval of insurance policy forms and rates; inspection of insurer underwriting and claims handling practices; and evaluation of insurer sales and marketing practices.

State insurance regulators also are responsible for oversight of insurance agents and brokers. Regulators issue licenses to qualifying agents and brokers and monitor the conduct of agents and brokers in the marketplace. Additionally, state insurance regulators investigate complaints lodged by consumers against insurance companies, agents and brokers.

WHY DOES THE FEDERAL GOVERNMENT GET INTO THE INSURANCE BUSINESS?

Typically, the federal government steps in when the property/casualty insurance industry cannot meet the needs of the public. Traditionally, the government intervenes only when risks are very large (such as nuclear liability or terrorism) or where there is a strong element of "adverse selection" that precludes private underwriting of the risk.

Adverse selection occurs when there are more poor risks than good risks seeking to buy insurance. For instance, only people who face a flood risk are likely to buy flood insurance and young people are less likely to purchase health coverage because they believe they are healthy and do not need it. In an adverse selection situation, an insurer cannot write a spread of risk that includes a spectrum from good to bad, and increased claims costs will eventually threaten the financial health of the company. Some types of property/casualty insurance coverage that currently could be predisposed to adverse selection problems include coverage for windstorms and for terrorist events. There is a strong possibility that the federal government will play an even larger role in catastrophe insurance for major natural catastrophes because those events, like terrorist attacks, cause losses that can threaten the solvency of the insurance industry.

The federal government has also become involved in the administration of employee benefits like health insurance and pensions through the Employee Retirement Income Security Act (ERISA), originally enacted in 1974. ERISA was designed to provide minimum standards for the administration of employee pension programs following several abuses that became public during the 1960s and early 1970s. It has been amended several times to expand its scope to provide for federal standards governing employer-sponsored health benefit programs. However, it does not require employers to offer either pension or health benefit plans.

WHAT ARE SOME EXAMPLES OF DIRECT FEDERAL INVOLVEMENT IN THE INSURANCE INDUSTRY?

The Federal Insurance Administration administers the National Flood Insurance Program (NFIP). It is an agency within the Federal Emergency Management Administration (FEMA). With the cooperation of the insurance industry, Congress enacted the National Flood Insurance Act of 1968, which established the NFIP. The program makes flood insurance available to property owners in every state. Flood insurance may be purchased through agents and brokers who work with the NFIP or through insurers who participate in the NFIP's "Write Your Own" program. In 2007, the NFIP issued more than 5.6 million polices totaling more than $1.1 billion in coverage. [9]

The Treasury Department administers the Terrorism Risk Insurance Program (TRIP). The Terrorism Risk Insurance Program was developed with assistance from the industry in response to the terrorist attacks of 9/11, and the resulting unavailability of coverage for acts of terrorism in the commercial insurance market. TRIP acts as a reinsurance backstop for terrorism losses. Insurance company losses from a terrorism event are reimbursed by the U.S. Treasury to the extent that the losses exceed the company's deductible for the program.

9 NFIP website

The Federal Crop Insurance Corporation (FCIC), an agency of the Department of Agriculture, offers crop insurance on a limited basis. Crops, particularly in the Midwest, are vulnerable to many dangers that could destroy a harvest and result in financial ruin for the farmer. The FCIC also provides reinsurance to private insurers who underwrite crop insurance.

The Price-Anderson Nuclear Indemnities Act (Price-Anderson) also serves as a government backstop for liability losses involving the nuclear power industry. Price-Anderson was enacted in 1957 in response to the difficulties private entities faced in obtaining liability insurance for the development of nuclear facilities and has been renewed several times. Under the Act's 2005 revisions, private entities will cover up to $10 billion of claims from a nuclear incident and the federal government will cover claims exceeding that amount.

The Overseas Private Investment Corporation (OPIC) encourages U.S. investment in developing countries. Assistance programs include political risk insurance to protect these investments. The political risk insurance covers expropriation, inconvertibility of local currency holdings and damage from war, revolution or insurrection. It also offers U.S. lenders political risk protection by guaranteeing payments of principal and interest on loans made to private enterprises. Since 1971, OPIC has recorded a positive net income and has accumulated reserves of more than $3.15 billion at no cost to U.S. taxpayers. OPIC premiums in 2007 totaled more than $25 million.[10]

WHAT FEDERAL LAWS INCLUDE FINANCIAL RESPONSIBILITY PROVISIONS?

Several federal statutes require certain businesses to maintain the ability to pay for any harm caused by their operations. The principal laws requiring business to carry insurance or some form of financial responsibility are:

- **Superfund:** Requires persons responsible for release of toxic wastes to clean up the sites or to reimburse the government for clean up.
- **Motor Carrier Act:** Requires a common or contract carrier to carry insurance sufficient to satisfy the minimum public liability requirements to pay for losses due to bodily injury, property damage and environmental restoration, especially when hazardous cargo is involved. This includes buses, which were added to the Motor Carrier Act by the Bus Regulatory Reform Act of 1982.

In addition to these programs, others are being considered. For example, there are proposals circulating to establish a federally mandated health insurance program. Another example is natural catastrophes. Among the proposals being discussed is one that would require persons living in high flood risk areas to participate in the NFIP if they are to be considered eligible for federal disaster assistance. These trends beg the question of how large a role the federal government should or will play in catastrophic loss mitigation.

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10 OPIC 2007 Annual Report

WHAT PROBLEMS ARISE WHEN FEDERAL LAW MANDATES PURCHASE OF INSURANCE OR SETS FINANCIAL RESPONSIBILITY REQUIREMENTS?

When Congress mandates financial responsibility requirements, the insurance market may be affected. If the government were to require private underwriters to insure all businesses, it would restrict the underwriter's ability to select legitimate risks. This would ultimately result in withdrawal of capacity as well as insurer insolvencies. Additionally, novel standards of liability or open-ended risks remove the predictability insurers must have to properly underwrite risks.

Insurance, by necessity, is selective. For example, when insurers cannot justify underwriting the risks of a business, that business may be forced to close because it cannot meet government-mandated financial responsibility requirements.

WHAT IS THE GRAMM-LEACH-BLILEY ACT AND HOW DID IT AFFECT INSURANCE?

It is not an exaggeration to say that the 1999 Gramm-Leach-Bliley Act had an unprecedented impact on state insurance regulation. The law recognizes the fact that financial services have become increasingly integrated in a business atmosphere defined by consolidation, driven by a global economy and fueled by electronic commerce. It permits banks, insurers and securities firms to own each other; allows nationally chartered banks to expand their activities into areas such as insurance sales; and safeguards consumer privacy by providing control over how personal information is shared.

Gramm-Leach-Bliley affects the regulation of the insurance industry in two major ways. One provision required a majority of states to reach either reciprocity or uniformity in producer licensing laws within three years of the law's enactment. If the states failed to meet this goal, a new federal regulatory agency, the National Association of Registered Agents and Brokers (NARAB), would have been created to act as a clearinghouse for multistate licensing of insurance producers, making it easier for agents and brokers to conduct business in multiple states. While a majority of states did enact the necessary statutory changes to meet the reciprocity requirements of NARAB by the deadline of November 2002, it is not clear that the states have held fast to the reciprocity requirements.

Gramm-Leach-Bliley also contained sweeping new provisions governing the privacy of consumers' confidential financial information. Because there is no entity at the federal level that regulates insurers, the National Association of Insurance Commissioners was given the responsibility for developing the rules that insurers must follow to comply with the privacy provisions of the law. However, these rules are largely modeled after the rules developed by federal banking and securities regulators.

While not having much of a direct effect on state regulation of insurance outside of the producer licensing and privacy regulation areas, Gramm-Leach-Bliley has had an indirect effect of highlighting the disparity among state insurance laws in other areas of regulation. The National Association of Insurance Commissioners has pledged to modernize and unify the state-based system of insurance regulation several times since the enactment of Gramm-Leach-Bliley, but there has been little change.

WHAT DOES THE FUTURE HOLD FOR HOW INSURANCE IS REGULATED?

In light of the increasing globalization of business, the ongoing consolidation trends among financial services players and the ease of transacting business electronically, it is unclear whether the state-based regulatory system can meet the future needs of insurance consumers and the industry. A fundamental question remains as to whether the current system is the most effective way to regulate a complex, global industry which is converging with banking and other financial services markets. The current system is characterized by a patchwork of state laws and regulations that often are in conflict. It has become increasingly difficult, for example, for any one state to regulate large national and global insurance enterprises, especially for solvency.

Regulatory roles also may change depending on ownership and control of merged businesses resulting from consolidations of banks and insurance entities. Traditionally, banks are regulated at the federal and the state level, and insurers, agents and brokers are regulated only at the state level. A merged entity is regulated at both levels. This presents the opportunity for conflicting regulatory requirements for each of the businesses and also increases the administrative costs for the merged entities, which must deal with two sets of regulators.

There is a real question of whether the state-based system is up to the task. The increasingly global scope of commerce means that there is a possibility that all forms of insurance, including reinsurance, will eventually be regulated at the federal level and perhaps even at the global level. For example, the European Union is putting in place a framework, known as Solvency II, for regulating the solvency of insurance companies. EU officials hope the framework will be a global model for solvency regulation, and U.S. insurance regulators have begun to examine the proposal. The market realities of consolidation and competition, coupled with the increasingly global nature of commerce, will set the stage for re-examination of the current regulatory system. This review will go far beyond the question of state-versus-federal regulation. The real concern is which new or existing structure will best serve insurers, agents and brokers and their customers.◆

VI. THE FUTURE OF THE INSURANCE INDUSTRY

HOW IS THE BUSINESS OF INSURANCE CHANGING?

Insurance, by necessity, has always been responsive to the society it serves. But the recent dramatic changes that are molding industry and society in general are accelerating change within the insurance industry.

The 1999 Gramm-Leach-Bliley Act was expected to accelerate deals involving insurance firms and other financial entities such as banks, thrifts and securities firms. However, mergers between banks and insurers have not been as common as expected. Instead, banks have seen more opportunity on the distribution side of the business and have merged with regional and national insurance agents and brokers. Private equity investors also have entered the market and purchased a number of prominent insurance brokers. The mergers and acquisition activity is expected to continue on the distribution side with firms growing larger in order to compete for market share, particularly on the commercial side of the business. Smaller, less diverse independent insurance agencies increasingly will face the choice of merging with other similar firms or selling to larger firms.

Another trend is the purchase of U.S. insurance companies by international insurance companies. The current low value of the U.S. dollar against the Euro could entice European insurers to purchase U.S. insurers.

Gramm-Leach-Bliley has also encouraged internal company innovations to expand organically into new businesses. For example, several personal lines insurance companies have formed banks since the enactment of Gramm-Leach-Bliley. These changes are creating new synergies for sellers and buyers of financial services.

There are other changes, too. Insurers, responding to market trends, are rethinking their traditional distribution methods and experimenting with combinations and direct sales over the Internet. And without a doubt, other unforeseen changes will have an impact on the industry as well.

WHAT EFFECT DOES THE GLOBALIZATION OF COMMERCE HAVE ON THE INDUSTRY?

The increasing use of electronic communications and e-commerce has given even the smallest of businesses an opportunity to operate on a national and international basis.

This "globalization" of commerce has led to a blurring of borders in many ways, as a consumer may now buy goods from almost anywhere in the world with the click of a mouse. It has also made consumer goods from countries outside the United States much more available here, and U.S. goods much more available around the world. This has opened up a whole new set of opportunities for the insurance industry, and for agents and brokers in particular, many of whom may now find themselves assisting clients who have multi-national risks even if they are not multi-national companies.

The increasing globalization of commerce has posed a challenge for the insurance industry, particularly the U.S. insurance industry, which is regulated on a state-by-state basis. This stands in stark contrast to insurers and producers in other countries, where there is generally one regulatory scheme. Even the European Union (EU), which is comprised of 27 member countries from Western, Eastern and Central Europe, has a unified regulatory system that promotes the transaction of cross-border business. Although the EU has not completely achieved its goal of seamless regulation throughout the Union, it nonetheless remains on the cutting edge of modern financial services regulation. The EU recognizes that in order to remain competitive in the global economy, its financial services industry must be regulated in ways that protect consumers while promoting economic growth. Developments in the EU are influencing U.S. regulators and may be another catalyst for change from state to federal insurance regulation.

The U.S. insurance regulatory system increasingly is seen as a trade barrier by other countries which feel that the process of obtaining licenses to do business in every state is overly burdensome—especially when U.S. insurers and producers can transact business in areas like the European Union without jumping through numerous regulatory hoops. U.S. trading partners have begun to press this case with U.S. trade negotiators, but so far, there have been few strides to streamline the state-based regulatory system.

Through the efforts of individual insurance companies and trade associations, the insurance industry is becoming increasingly proactive in addressing change. For example, organizations such as the World Federation of Insurance Intermediaries (WFII), in partnership with broker and agent groups in five world regions, are involved in the ongoing World Trade Organization talks. Their goal is to liberalize trade in insurance services, push for open markets in all corners of the globe and ensure a level playing field for all insurance intermediaries so they can compete on equal footing with other players in the marketplace. In addition, the U.S. insurance industry and insurance regulators are becoming increasingly involved in working with international insurance regulators to harmonize regulatory requirements.

The International Association of Insurance Supervisors (IAIS), a body of insurance regulators and supervisors around the world, has developed numerous model principles for regulating the insurance industry. These models are used by developing and developed countries alike as guidelines for regulating the industry. They have the practical effect of setting international guidelines for regulating insurance.

Today's insurance regulators cannot just wait on the sidelines for something to happen. They must be actively involved in promoting economic growth and development and protecting consumers in their countries by working for a modern regulatory system and competitive trading environment that are flexible, up-to-date and responsive to industry and consumer needs.◆

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of INSURANCE
AGENTS & BROKERS
Count on THE COUNCIL™

701 Pennsylvania Avenue, NW, Suite 750
Washington, DC 20004-2608

T: (202) 783-4400
F: (202) 783 4410
E: ciab@ciab.com
W: www.ciab.com

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FOUNDATION
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