Segment B

Assignment 4
Marketing

Assignment 5
Underwriting and Ratemaking

Assignment 6
Claims

Direct Your Learning

4

Marketing

Educational Objectives

After learning the content of this assignment, you should be able to:

- Describe the following factors that influence an agency relationship:
  - Legal roles
  - Legal responsibilities
  - Scope of authority
- Summarize the various types of insurance distribution systems and alternative marketing channels.
- Describe the functions performed by insurance producers.
- Describe the key factors an insurer should evaluate during the distribution-system and distribution-channel selection process.
- Explain how states regulate insurance marketing activities in these areas:
  - Licensing
  - Compensation
  - Unfair trade practices

Outline

Marketing

4

UNDERSTANDING FACTORS THAT INFLUENCE AN AGENCY RELATIONSHIP

Insurers depend on marketing personnel such as producers, agents, brokers, and sales representatives to keep them informed about the changing needs and desires of customers. Most insurance marketing systems involve a salesperson who represents either insurers or insureds, or both.

In an insurance context, "**producer**" and "agent" are synonymous terms that refer to any person who sells insurance (produces business) for one or more insurers. The terms "broker" and "sales representative" are also used for special categories of producers. An **agent** engages in an **agency** relationship with a **principal**. In insurance, the principal is often an insurer. Three factors influence an agency relationship:

- Legal roles
- Legal responsibilities
- Scope of authority

Producer

Any of several kinds of insurance personnel who place insurance business with insurers and who represent either insurers or insureds, or both.

Agent

In the agency relationship, the party that is authorized by the principal to act on the principal's behalf.

Agency

A legal, consensual relationship that exists when one party, the agent, acts on behalf of another party, the principal.

Principal

The party in an agency relationship that authorizes the agent to act on that party's behalf.

Legal Roles

The agency relationship requires absolute trust between the principal and the agent because it imposes serious legal obligations on both parties. While the agent has authority to act for the principal, the principal has control over the agent's actions on the principal's behalf. This authority and control are the two essential elements of an agency relationship.

The principal gives the agent authority to act as its representative within certain guidelines. The principal may authorize the agent to do anything the principal can do. For example, an insurer (the principal) can authorize its agent to collect premiums from insureds for new insurance policies and then require the agent to remit those premiums (sometimes after deducting a commission) to the insurer within a certain amount of time.

The agency contract, also known as an agency agreement, is a written agreement between an insurer and an agent that specifies the scope of the agent's authority to conduct business for the insurer. It gives the agent the right to represent the insurer and to sell insurance on the insurer's behalf. The contract specifies the compensation arrangement between the insurer and the agent. It also describes how the agency relationship can be terminated.

Insurance agency contracts usually have no fixed expiration date and remain in force until one party cancels the contract after giving proper notice to the other party, as required by the contract.

Legal Responsibilities

In an agency relationship, the agent's fundamental responsibility is to act for the benefit of the principal. Just as the agent owes duties to the principal, the principal legally owes certain duties to the agent. An agency relationship also creates responsibilities to third parties.

Legal Responsibilities of the Agent to the Principal

The laws of agency impose five duties on all agents, including insurance agents:

- Be loyal to the principal.
- Obey the principal's lawful instructions.
- Exercise a reasonable degree of care in actions on behalf of the principal. The agent must act as a reasonably prudent person would under the same or similar circumstances.
- Account promptly for any of the principal's money that the agent holds. Under the duty of accounting, the agent is responsible to the principal for all of the principal's money and property that comes into the agent's possession.
- Keep the principal informed of all facts relating to the agency relationship. This is the duty of relaying information.

In insurance, an agency contract specifically addresses certain rights and duties of the agent. For example, the contract explicitly describes the insurance agent's right to make insurance coverage effective and any limitations on that right. The contract also specifies how the agent is to handle funds, including stipulations on how and when the agent must remit premiums to the insurer. Insurance agency contracts usually give the agent the right to employ subagents, who may act on behalf of the insurer according to the terms of the agency contract.

Legal Responsibilities of the Principal to the Agent

In the case of an insurance agent, the principal's duty to pay the agent for services performed requires the insurer to pay commissions and other specified compensation to the agent for the insurance the agent sells or renews. The principal also has a duty to indemnify, or reimburse, the agent for any losses or damages suffered without the agent's fault, but arising out of the agent's actions on behalf of the principal. If a third party sues the agent in connection with activities performed on behalf of the principal, the principal must reimburse the agent for any liability incurred, if the agent was not at fault.

However, no reimbursement is due if the agent acted illegally or without the principal's authorization, even though the principal may be liable to others for those acts. An important factor involved in this duty is the exposure of insurance agents to errors and omissions (E&O) claims, which may arise from an agent's negligent actions. For example, when an insurance agent gives a customer misleading or incorrect advice regarding the customer's insurance, the customer could bring an E&O claim against the agent if the customer suffers damage due to the agent's advice.

Responsibilities to Third Parties

The agent's authorized actions on behalf of the principal legally obligate the principal to third parties in the same way as if the principal acted alone. Therefore, from an insured's point of view, little distinction exists between the insurance agent and the insurer. Because the agent represents the insurer, the law presumes that knowledge acquired by the agent is knowledge acquired by the insurer.

If, for example, the agent visits the insured's premises and recognizes an exposure (such as vacancy of the building) that could suspend or void the insured's policy, the insurer cannot deny a claim to the insured merely because the agent failed to communicate that information to the insurer. According to agency law, the fact that the agent knew about the exposure means that the insurer is also presumed to know about it.

Scope of Authority

From a third party's perspective, an agent's authority can be either actual or apparent.

Actual Authority

Actual authority can be **express authority** or **implied authority**. Express authority applies not just to carrying out the principal's specific instructions, but also to performing acts incidental to carrying out those instructions. To determine the scope of express authority, courts examine the goals of the agency in light of all surrounding circumstances. For example, the power to sell generally includes authority to collect payment and to make customary warranties. However, to illustrate consideration of scope, a sales agent who has no possession or indication of ownership of merchandise has no authority to collect the purchase price. In most commercial situations, the agent has authority only to solicit orders or to produce a buyer with whom the principal can deal.

Binding authority, generally granted to the agent in the agency contract, is a form of express authority. Binding coverage is usually accomplished by issuing binders, which are agreements to provide temporary insurance coverage until a formal written policy is issued. Binders can be either written or oral. When

Implied authority
The authority implicitly conferred on an agent by custom, usage, or a principal's conduct indicating intention to confer such authority.

Express authority
The authority that the principal specifically grants to the agent.

Actual authority
Authority (express or implied) conferred by the principal on an agent under an agency contract.

Binding authority
An insurance agent's authority to effect coverage on behalf of the insurer.

an insurance agent binds coverage for a new client, the agent commits the insurer to covering an exposure for, and possibly paying a claim to, a customer who is unknown to the insurer. Binding authority involves important responsibilities for the agent, and agents are expected to use their binding authority carefully. See the exhibit "Binding Authority: An Example."

Binding Authority: An Example

Assume Christopher owns an old car for which he has an automobile policy with no collision coverage. Christopher purchases a new car and calls his insurance agent, Lisa, to make sure the car is covered before he drives it off the dealer's lot. Reminding Christopher that he has no collision coverage, Lisa gives him a quote for collision coverage on the new car. Lisa and Christopher agree that Lisa will immediately add the new car to Christopher's policy, including collision coverage with a $250 deductible. Christopher agrees to pay the premium when he receives an invoice, and Lisa assures Christopher that "coverage is bound." Lisa then begins to process the paperwork necessary to issue a policy change (called an endorsement) that includes collision and other coverages on Christopher's new car. If Christopher should have an accident before receiving the policy endorsement, he would have collision coverage on his new car because Lisa issued an oral binder. The binder is temporary because it will be replaced by a policy endorsement.

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Custom is the most common source of implied authority. Agents can reasonably infer that they have authority to act according to prevailing custom unless the principal gives different instructions. Without different instructions, an agent's authority extends to, and is limited to, what a person in this agent's position usually does.

Implied authority can also apply when an agent acts beyond the usual scope of authority in an emergency. If the agent needs to act to protect or preserve the principal's property or rights but is unable to contact the principal, and if the agent reasonably believes that an emergency exists, he or she has authority to act beyond, or even contrary to, the principal's instructions. An agent who acts reasonably in an emergency has authority to act even if the agent is mistaken about the necessity for the actions or is at fault in creating the emergency. The agent, however, can be liable to the principal for any expenses resulting from the agent's wrongful conduct.

Apparent Authority

Apparent authority

A third party's reasonable belief that an agent has authority to act on the principal's behalf.

Unlike actual authority, a principal neither confers apparent authority on an agent nor creates it. **Apparent authority** is based on appearances and includes all the authority that a reasonable person acquainted with the customs and nature of the business could reasonably assume the agent has. It generally arises in one of two overlapping circumstances:

- A principal grants less authority than agents in the same position in that business usually have.
- The method of operation of the principal's business differs from that of other businesses of the same kind in the principal's area.

For example, principal Paul instructs agent Ann not to sell goods on credit if the total credit to a customer exceeds $200, an unusual restriction in Paul's business. Ann sells goods on credit to Lee for $250 with no actual authority to do so. Lee, however, neither knows nor had reason to know of the restriction. A third party could have reasonably believed that Ann had the usual authority in that situation. The authority was apparent, and Paul cannot deny it.

As a second example, Paul puts Ann in charge of a jewelry store and instructs her not to stock or sell watch batteries. All other jewelry stores in that area do stock and sell watch batteries. Ann contracts with Larry to purchase a supply of watch batteries. Ann has apparent authority to do this as long as Larry is unaware of the restriction on Ann's authority.

SUMMARIZING TYPES OF INSURANCE DISTRIBUTION SYSTEMS

Insurers use many types of distribution systems based on their organizational structure, business and marketing plans, growth goals, technological capabilities, staffing, and other resources.

Insurance distribution systems differ in their relationship to the insurer and customers, ownership of expirations, compensation methods, and functions performed. Insurers use several common distribution channels to promote products and services as well as to communicate with existing and prospective insureds.

These are the main insurance distribution systems:

- Independent agency and brokerage marketing system
- Exclusive agency marketing system
- Direct writer marketing system

Independent Agency and Brokerage Marketing System

The independent agency and brokerage marketing system uses agents and brokers who are independent contractors rather than employees of insurers. These independent agents and brokers are usually free to represent as many or as few insurers as they want.

Independent Agents and Brokers

Independent agency

A business, operated for the benefit of its owner (or owners) that sells insurance, usually as a representative of several unrelated insurers.

Broker

An independent producer who represents insurance customers.

Agency expiration list

The record of an insurance agency's present policyholders and the dates their policies expire.

An **independent agency** or brokerage can be organized as a sole proprietorship, a partnership, or a corporation. **Brokers** shop among insurers to find the best coverage and value for their clients. Because they are not legal representatives of the insurer, brokers are not likely to have authority to commit an insurer to write a policy by binding coverage, unlike agents, who generally have binding authority.

One vital distinction between independent agents and brokers and other distribution systems is the ownership of the **agency expiration list**. If the insurer ceases to do business with an agency, the agency has the right to continue doing business with its existing customers by selling them insurance with another insurer. The ownership of expiration lists is an agency's most valuable asset. The agency—not the insurer—owns the business (though insureds have the right to place their business with any insurer they wish, whether with that agent or elsewhere). An independent agency has the right to sell its expiration lists to another independent agent.

Compensation for independent agents and brokers is typically in two forms:

- A flat percent commission on all new and renewal business submitted
- A contingent or profit-sharing commission based on volume or loss ratio goals

The independent agency and brokerage distribution system can meet the needs of many different insurance customers and is spread geographically across the United States. Agents and brokers may also assist their customers in establishing and managing self-insurance programs, implementing risk control measures, and determining alternatives or supplements to insurance. Some have draft authority from their insurers to settle small, first-party losses.

National and Regional Brokers

National and regional brokers generally represent commercial insurance accounts that often require sophisticated knowledge and service. In addition to insurance sales, large brokerage firms may provide extensive risk control, appraisal, actuarial, risk management, claim administration, and other insurance-related services. Large insurance brokerage firms operate regionally, nationally, and internationally. They can tailor insurance programs for customers or groups of customers who require a particular type of coverage for multiple locations. The brokers receive negotiated fees for the services they provide, or they receive fees in addition to commissions, subject to state regulation.

Independent agency network

A group of agencies that contractually link to share services, resources, and insurers to gain advantages normally available only to large regional and national brokers.

Independent Agency Networks

Independent agency networks—also known as agent groups, agent clusters, or agent alliances—operate nationally, regionally, or locally and, in the majority of cases, allow their agent-members to retain individual agency ownership and independence.

Managing General Agents

The exact duties and responsibilities of a **managing general agent (MGA)** depend on its contracts with the insurers it represents. MGAs can represent a single insurer, although they more commonly represent several insurers. Some MGAs can be strictly sales operations, appointing and supervising subagents or dealing with brokers within their contractual jurisdiction. That jurisdiction can be specified in terms of geographic boundaries, types of insurance, or both. A few MGAs cover large multistate territories, although frequently only for specialty insurance.

Managing general agent (MGA)
An authorized agent of the primary insurer that manages all or part of the primary insurer's insurance activities, usually in a specific geographic area.

An insurer operating through an MGA has several advantages:

- A low fixed cost
- Specialty expertise
- Assumption of insurer activities

Surplus Lines Brokers

Most agents and brokers are limited to placing business with licensed (or admitted) insurers. The circumstances under which business can be placed with an unlicensed (or nonadmitted) insurer through a surplus lines broker vary by state. Normally, a reasonable effort to place the coverage with a licensed insurer is required. The agents and brokers, who must be licensed to place surplus lines business in that state, might be required to certify that a specified number (often two or three) of licensed insurers have refused to provide the coverage. In some states, agents and brokers must provide letters from the insurers rejecting the coverage. Some state insurance departments maintain lists of coverages that are eligible for surplus lines treatment without first being rejected by licensed insurers. Some states also maintain lists of eligible surplus lines insurers, requiring producers to place business only with financially sound insurers.

Surplus lines brokers have access to insurers that have the capacity to provide the needed insurance, which might not be available from insurers licensed to do business in the state. Surplus lines brokers work to ensure that coverage is placed only with eligible nonadmitted insurers, the customer's unique or unusual requirements can be met by the prospective surplus lines insurer, and the financial security of the surplus lines insurer is properly evaluated. Surplus lines brokers, like national or regional brokers, maintain their independence, can represent multiple insurers, and are compensated based on a portion of the commissions generated by the business they write.

Exclusive Agency Marketing System

Exclusive agency marketing system

An insurance marketing system under which agents contract to sell insurance exclusively for one insurer (or for an associated group of insurers).

The **exclusive agency marketing system** uses independent contractors called exclusive agents (or captive agents), who are not employees of insurers. Exclusive agents are usually restricted by contract to representing a single insurer. Consequently, insurer management can exercise greater control over exclusive agents than over independent agents. However, some exclusive agency companies allow their agents to place business with other insurers if the exclusive agency insurer does not offer the product or service needed.

Exclusive agents are usually compensated by commissions. For exclusive agents, the focus is on new-business production, and a reduced renewal commission rate encourages sales and supports growth. Though exclusive agents typically do not own expirations as independent producers do, some insurers that market through the exclusive agency system do grant agents limited ownership of expirations.

The exclusive agency insurer handles many administrative functions for the exclusive agent, including policy issuance, premium collection, and claim processing. Exclusive agents might offer loss adjustment services similar to those offered by independent agents and brokers; however, these agents might be restricted in their ability to offer some risk management services to their customers.

Direct Writer Marketing System

Direct writer marketing system

An insurance marketing system that uses sales agents (or sales representatives) who are direct employees of the insurer.

Sales agents in the **direct writer marketing system** may be compensated by salary, by commission, or by both salary and a portion of the commission generated. Because sales agents are employees of the insurers they represent, they usually do not have any ownership of expirations and, like exclusive agents, are usually restricted to representing a single insurer or a group of insurers under common ownership and management. Sometimes a customer needs a type of policy not available from the direct writer insurer that the sales agent represents. When this happens, the sales agent may act as a broker by contacting an agent who represents another insurer and apply for insurance through that agent, who usually shares the commission with the direct writer sales agent. Insurance sold in this manner is referred to as brokered business.

Sales agents are largely relieved of administrative functions by their employers. These insurer-assumed functions include policy issuance, premium collections, and claim functions. Direct writer insurers should encourage their sales agents to develop new business. This can be accomplished by relieving producers of nonselling activities and compensating at a lower renewal rate.

Distribution Channels

The distribution channels used by insurers and their representatives are conduits for contacting and establishing communication with their customers and prospective customers.

Internet

As a distribution channel, the Internet can be used to varying degrees by all parties to the insurance transaction: the insurer, its representatives, and the customer. Interactions range from exchanges of e-mail to multiple-policy quoting, billing, and policy issuance. Customers also interact with insurers via Web-based insurance distributors, also called insurance portals or aggregators. These portals deliver leads to the insurers whose products they offer through their Web sites. Portals benefit customers by offering the products and services of many insurance providers on one Web site. Although the leads that portals generate must subsequently be screened and fully underwritten by the insurers accepting the coverage, they can increase an insurer's market share and brand awareness. See the exhibit "Internet Benefits and Challenges for Insurers."

Call Centers

The best-equipped call centers can replicate many of the activities of producers. In addition to making product sales, call center staff can respond to general inquiries, handle claim reporting, answer billing inquiries, and process policy endorsements. In some cases, a customer can begin an inquiry or a transaction on the Internet, then have a customer service representative at the insurer's call center access the Internet activity and answer the inquiry or conclude the transaction.

Direct Response

The direct response distribution channel markets directly to customers. No agent is involved; rather the direct response relies primarily on mail, phone, and/or Internet sales. Direct response relies heavily on advertising and targeting specific groups of affiliated customers. With direct response, commission costs, if any, are greatly reduced. However, a disadvantage is that advertising costs are typically higher. The customer can sometimes "opt out" and speak with a call-center customer service representative or be assigned to a local servicing office.

Group Marketing

Group marketing sells insurance products and services through call centers, the Internet, direct mail response, or a producer to individuals or businesses

Internet Benefits and Challenges for Insurers

Insurers and their representatives derive a number of benefits from having an Internet presence:

- Reduced costs for underwriting and claim processing services because of lower overhead arising from automated operations
- Streamlined business practices—the need for fewer employees to conduct direct sales
- Increased brand awareness
- Broadened marketing potential
- Lead-generation and cross-selling opportunities for all products, not just property-casualty insurance

However, Internet sales present challenges for insurers:

- Regulation requirements—Purchases transacted completely via the Internet may not meet regulatory compliance requirements that a licensed agent consummate the sale.
- Assumed cost advantage—Consumers perceive that a product bought over the Internet will be less expensive than the same product bought from a producer. These assumptions are not necessarily valid.
- Competitors are only a click away—If customers do not like what they see, they are likely to click to another, more favorable Web site.
- Quoting capabilities—An insurer's ability to quote easily and quickly is critical, because about 50 percent of users will simply move to another Web site if the quoting mechanism is too complicated.
- Availability of information—Many customers do not fully understand insurance products; the Internet largely eliminates intermediaries who would otherwise provide explanations and advice. Therefore, a Web site should maintain a frequently asked questions (FAQ) section and/or a "live contact."
- Extent of services provided—The insurer or producer must determine whether its Internet presence will be sales-only or a combination of sales and service.
- The informed consumer—Information about many insurance products and their prices is available to customers, shifting the customer's focus toward price rather than service.
- Security concerns—Some customers are unwilling to transmit personal and financial information over the Internet.
- Web site content—Information posted on the Web site must be kept fresh, interesting, and accessible.

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that are all members of the same organization. Distributing insurance to specifically targeted groups is known by a number of terms, including these:

- Affinity marketing—Insurers target various customer groups based on profession, interests, hobbies, or attitudes.

- Mass marketing or mass merchandising—Insurers design an offer for their policies to large numbers of targeted individuals or groups.
- Worksite marketing or payroll deduction—Employers can contract directly with an insurer or through a producer to offer voluntary insurance coverage as a benefit to their employees.
- Sponsorship marketing—A trade group sponsors an insurer in approaching a customer group. The sponsor participates in the profitability of the program.

Trade Associations

Trade associations serve their members through activities such as education, political lobbying, research, and advertising. The advertising programs are intended to create a favorable image of association members as a group and to make the public familiar with the logos and other association symbols. See the exhibit "Producers' Trade Associations."

Producers' Trade Associations

- Most independent agents are members of the Independent Insurance Agents & Brokers of America (IIABA), the National Association of Professional Insurance Agents (PIA), or both. The IIABA is often called the "Big I" because of the prominent letter "I" in its advertising logo. (In some states, IIABA and PIA have consolidated to form one state insurance agents' association.)
- The Council of Insurance Agents and Brokers (CIAB) includes independent agents and brokers associated with large agencies or brokerage firms that primarily handle commercial insurance.
- Many managing general agents are members of the American Association of Managing General Agents (AAMGA), which, like agents' and brokers' associations, also provides various services to its members.

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Financial Institutions

Insurers and producers can elect to market their products and services through a bank or another financial services institution, either exclusively or through additional distribution channels. Marketing arrangements can range from simple to complex. The prospect of diversifying into new markets appeals to many financial institutions. In fact, some financial institutions have expanded into insurance by participating in renewal rights arrangements by which they purchase only a book of business and not the liabilities of an agency or insurer.

Insurers view financial institutions as beneficial strategic partners because of these qualities:

- Strong customer base
- Predisposition to product cross-selling
- Strength at processing transactions
- Efficient use of technology for database mining geared to specific products and services

Mixed Marketing System

Mixed marketing system
An insurer's use of more than one marketing system or distribution channel.

A **mixed marketing system** requires consideration of several issues:

- Maintaining consistent customer communications
- Providing a consistent customer experience
- Matching the type of insurance with an appropriate distribution system and channel

FUNCTIONS OF INSURANCE PRODUCERS

The functions insurance producers perform vary widely from one marketing system to another and from one producer to another within a given marketing system. Generally, producers are the initial contact with insurance customers and provide expertise and ongoing services.

Insurance producers represent one or more insurance companies. As a source of insurance knowledge for their customers, producers provide risk management advice, solicit or sell insurance, and provide follow-up services as customers' loss exposures or concerns change.

Insurance producers typically perform these functions:

- Prospecting
- Risk management review
- Sales
- Policy issuance
- Premium collection
- Customer service
- Claim handling
- Consulting

Prospecting

Virtually all producers prospect. Prospecting involves locating persons, businesses, and other entities that may be interested in purchasing the insurance products and services offered by the producer's principals. Prospects can be located using several methods:

- Referrals from present clients
- Referrals from strategic partners, such as financial institutions and real estate brokers
- Advertising in multimedia and direct mail
- Interactive Web sites
- Telephone solicitations
- **Cold canvass**

Cold canvass
Contacting a prospect without an appointment.

Large agencies and brokerages may have employees who specialize in locating prospective clients. However, a producer is typically responsible for his or her own prospecting. Insurers might also participate in prospecting, especially in the exclusive agent and direct writer marketing systems.

Risk Management Review

Risk management review is the principal method of determining a prospect's insurance needs. The extent of the review varies based on customers and their characteristics.

Individual or Family

For an individual or a family, the risk management review process might be relatively simple, requiring an interview or completion of a questionnaire that assists in identifying the prospect's loss exposures, which are often associated with property ownership and activities. Using the results of the interview or questionnaire, the producer suggests methods of risk control, retention of loss exposures, and insurance.

Businesses

The risk management review process for businesses is likely to be more complex because they have property ownership, products, services, employees, and liabilities that are unique to the size and type of organization. Substantial time is required to develop and analyze loss exposure information for a large firm with diversified operations.

A **loss run** report can guide the producer in helping the business owner develop risk management plans, track the results of current risk management efforts, identify problem areas, and project costs. Loss runs include, at a minimum, lists of losses and their total cost. More comprehensive loss runs provide details that can lead to additional questions and suggest areas of risk management improvement. For example, comprehensive workers compensation loss runs reveal lag times in reporting, creating potentially higher costs. These reports can also indicate litigation rate; a high rate can be an indication of

Loss run
A report detailing an insured's history of claims that have occurred over a specific period, valued as of a specific date.

poor communication between employers and employees or overall employee dissatisfaction.

Sales

Selling insurance products and services is one of the most important activities of an insurance producer because it is essential to sustaining the livelihood of the agency or brokerage. Commission on business sold is the principal source of income for producers, and the ownership of policy expirations applicable to the business sold is the principal asset of an insurance agency.

Steps in the sales process include contacting the prospective client, determining the prospect's needs, preparing and presenting a proposal, and closing the sale.

Policy Issuance

At the producer's request, insurers issue policies and their associated forms, either mailing them directly to policyholders or sending them to the producer for delivery. In paperless environments, the policies and forms may be produced on a compact disk or placed in an Internet filing cabinet along with endorsements, bills, and loss history information.

Some producers use their own agency management systems to generate computer-issued policies on site.

Premium Collection

Agency bill

A payment procedure in which a producer sends premium bills to the insured, collects the premium, and sends the premium to the insurer, less any applicable commission.

Producers who issue policies may also prepare policy invoices and collect premiums. After deducting their commissions, they send the net premiums to the insurers, a procedure known as the **agency bill** process. For business that is agency billed, there are three widely used methods of transmitting premiums to the insurer:

- Item basis—The premium (less commission) is forwarded to the insurer when the producer collects it or when it becomes due. This is the least complex of the three methods. The producer is usually not required to pay the insurer until the premium has been collected.
- Statement basis—The insurer sends a statement to the producer showing the premiums that are due. The producer is obligated to pay the premiums indicated as due or to show that the statement is in error.
- Account current basis—The producer periodically prepares a statement showing the premiums due to the insurer, after deducting appropriate commissions, and transmits that amount to the insurer. The agency contract indicates how often the producer must submit the account current statement. The most common interval is monthly. The producer must pay the insurer when the premium is due, even if the policyholders have not paid the producer.

To give the producer some protection against policyholders' late payments, premiums are usually not due to the insurer until thirty or forty-five days after the policy's effective date. This delay also permits the producer to invest the premiums collected until they are due to the insurer. The resulting investment income can be a significant part of the producer's remuneration.

Agency billing may be used for personal insurance policies, but it is more commonly used with large commercial accounts. For small commercial accounts and the vast majority of personal insurance, the customer is usually directed to send premium payments to the insurer, bypassing the producer in a procedure known as the **direct bill** process.

Direct bill

A payment procedure in which the insurer assumes all responsibility for sending premium bills to the insured, collecting the premium, and sending any commission payable on the premium collected to the producer.

Customer Service

Most producers are involved to some degree in customer service. For independent agents and brokers, value-added services and the personalization of insurance packages are what differentiate them in the marketplace. For the producer of a direct writer, service might consist of providing advice, taking an endorsement request over the phone, providing coverage quotes, or transferring a policyholder who has had a loss to the claim department.

Producers are expected to facilitate contacts between policyholders and the insurer, including these:

- Responding to billing inquiries
- Performing customer account reviews
- Engaging in field underwriting, such as obtaining loss reports, insurance credit scores, and motor vehicle reports
- Answering questions regarding existing coverage and additional coverage requirements
- Corresponding with premium auditors and risk control representatives

Claim Handling

All producers are likely to be involved to some extent in handling claims filed by their policyholders. Because the producer is the policyholder's principal contact with the insurer, the policyholder naturally contacts the producer first when a claim occurs.

In some cases, the producer might simply give the policyholder the telephone number of the claim department and possibly the name of a person to speak with. Alternatively, the producer might obtain some basic information about the claim from the policyholder, relay it to the insurer, and arrange for a claim representative to contact the policyholder. Frequently, insurers issue their policies with a "claim kit" that informs their policyholders about the proper procedures and contacts.

Some producers are authorized by their insurers to adjust some types of claims. Most often, the authorization is limited to small first-party property claims. However, a few large agencies or brokerages that employ skilled claim personnel might be authorized to settle large, more complex claims. The limitations on the producer's claim-handling authority should be specified in the agency contract.

Claim handling by qualified producers offers two major advantages: quicker service to policyholders and lower loss adjustment expenses to the insurer. Conversely, if the producer is not properly trained in how to handle claims, overpayment of claims can offset the savings.

Consulting

Many producers offer consulting services, for which they are paid on a fee basis. Such services are usually performed for insureds, but they may also be performed for noninsureds or for prospects. Services might be provided for a fee only, or the producer might set a maximum fee to be reduced by any commissions received on insurance written because of the consulting contract.

Laws in some states prohibit agents from receiving both commission and a fee from the same client. Fees are billed separately from any insurance premiums due, whereas commissions are included in the premium totals billed.

DISTRIBUTION SYSTEM AND CHANNEL SELECTION FOR INSURANCE MARKETING

Any firm that sells a product has a distribution system to carry out some of its marketing functions. Distribution systems for intangible products, such as insurance, are more flexible and adaptable than those for tangible products because they are not constrained by large investments in physical facilities. This intangibility gives insurers options to meet a wide array of customers' needs as well as their own operational needs. Distribution channels provide even more options for communicating with existing and potential customers.

Insurance distribution systems and channels provide the necessary people, physical facilities, and conduits for communication between insurers and customers.

An insurer usually selects a distribution system before it begins writing business. Changing distribution systems for existing business can be difficult and possibly expensive because of existing agency contracts and possible ownership of expirations. However, an insurer that has previously chosen one distribution system might decide to use a different one when entering a new territory or launching a new insurance product. In contrast, distribution channels selected by insurers and their representatives are more readily changeable.

The key factors in selecting distribution systems and channels are based on customers' needs and characteristics as well as the insurer's profile. See the exhibit "Distribution Systems and Conduits for Insurance Marketing."

Distribution Systems and Conduits for Insurance Marketing

Distribution systems consist of the necessary people and physical facilities to support the sale of the insurance product and services.	Independent agency and brokerage marketing system • Independent agents and brokers • National and regional brokers • Independent agent networks • Managing general agents (MGAs) • Surplus lines brokers Exclusive agency marketing system Direct writer marketing system
Distribution channels are communication conduits for promoting and servicing products as well as communicating with existing and prospective insureds.	• Internet • Call centers • Direct response • Group marketing • Financial institutions

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Customers' Needs and Characteristics

The needs and characteristics of customers—both existing and those in target markets—are key factors in an insurer's selection of distribution systems and channels because their satisfaction drives their purchase decisions. These are examples of customer needs and characteristics:

- Products and services—What are customers' expectations regarding coverage, accessibility, price, and service? Customers with low service expectations, such as purchasers of minimum-coverage personal auto insurance, may be satisfied with the ease of comparison shopping over the Internet for direct writers' policies. Conversely, a large commercial account's risk manager will seek the expertise of an agent or broker to provide advice, assist in coverage placement, and respond to changing needs as the organization's internal and external environments change.
- Price—To what degree is the price of products and services a factor for customers? Some consumers' paramount concern is the price of insurance. Others are concerned with price to a degree, but are unlikely to make changes if they are satisfied with a product. Still others seek risk manage-

ment alternatives, including insurance that will minimize the adverse effects of losses for the organization over the long term.

- Response time—How quickly can inquiries and transactions be processed? Customers routinely experience speedy financial services transactions and increasingly expect the same response from their insurance providers. For those customers whose inquiries and transactions can be addressed by telephone or via the Internet, a variety of distribution systems and channels can meet those needs. However, speed can be an issue in attracting commercial accounts that demand extensive services if producers are not in the territory of the businesses' facilities.

Insurer's Profile

An insurer's profile—including its strategies and goals, strengths, existing and target markets, geographic location, and the degree of control over producers it requires or desires—frames the business and marketing environments within which it operates. The insurer must evaluate these key factors in selecting distribution systems and channels.

Insurer Strategies and Goals

An insurer's strategies, defined by high-level organizational goals, provide purposeful direction for the organization. These strategies and goals often address issues regarding market share size, sales, service, and the markets in which the insurer competes. They may also relate to acquisitions, strategic alliances, or mergers.

Changes in market strategies or aggressive goals can be a catalyst for an insurer to reexamine its distribution systems and channels if current approaches are inadequate to achieve required results. For example, a regional personal lines insurer that contracts independent agents as a distribution system may adopt a strategy to expand to the national market. Rather than contracting additional independent agents in the expanded geographic territory, the insurer assumes the role of a direct writer and uses the Internet as a distribution channel to reach customers through Web-based insurance distributors. This approach can reduce long-term costs and accelerate the insurer's market-share growth.

Insurer Strengths

Organizations evaluate their internal and external environments to assess their strengths and weaknesses compared to external opportunities and threats. Determining where its strengths lie, an insurer selects those distribution systems and channels that maximize its opportunities to capture market share and minimize its weaknesses. In doing so, the insurer may analyze these factors:

- Financial resources—The initial fixed cost of entering the market through the exclusive agency system or direct writer system is greater than doing so through the independent agency system. The insurer must hire, train, and financially support the direct writer and exclusive agency producers at substantial cost before they become productive. Similarly, Internet-based distribution channels have high start-up costs for supporting information systems. In comparison, the cost of conducting a direct response campaign can be much lower. Consequently, insurers with the financial resources to initiate distribution systems and channels with high start-up costs have the option of competing in markets that are best served by those marketing methods. Insurers that lack the financial resources to cover those start-up costs may be limited in the target markets they enter.
- Core capabilities—Core capabilities include the abilities of an organization's staff, processes, and technology. An insurer whose strength is successfully servicing large, complex commercial accounts can capitalize on the firm's core capabilities. Complex commercial accounts require personalized service and are well served by agents and brokers, who can provide advice and ongoing service to expand the types of businesses to which the insurer markets or its geographic market.
- Expertise and reputation of producers—Because agents and brokers are the point of contact with customers, their expertise and reputation can be a crucial strength or weakness for the insurer. The level of expertise required of a producer depends on the lines of insurance written. Specialty target markets, such as international manufacturing, high-net-worth individuals, and large public entities require knowledgeable and prominent producers to advise them. Having producers with those attributes in a direct writer distribution system allows the insurer to expand into similar or secondary markets. An insurer attempting to enter specialty markets without the skill base on staff must compete for agents and brokers who can provide the needed expertise and reputation.

Existing and Target Markets

The characteristics of an insurer's existing book of business should be considered in any change in distribution system or channel. If agents or brokers own the expirations for current accounts, the insurer must either give up that business and start over or purchase the expirations from producers. Either option might be expensive, depending on the quality of the existing business.

Disruptions in communication channels can also cause changes in communication patterns that can result in policyholder dissatisfaction and lost accounts. As a result, insurers change market systems and channels for existing customers with great caution. However, some catalysts are sufficiently threatening to cause an insurer to change marketing approaches. For example, an insurer that is losing market share to an aggressive new competitor has ample incentive to change its approach to better address customers' needs and characteristics.

Customers' needs and characteristics are driving factors for an insurer that is considering changing its marketing approach or adopting a mixed marketing approach for a new target market. If an insurer's existing distribution systems and channels do not adequately address the customers' profiles as determined through marketing research, the insurer is less likely to gain market share. To make an optimum choice, the insurer carefully balances the cost of changing its distribution systems and channels with expected benefits resulting from the new accounts it will write.

Geographic Location

The geographic location of existing policyholders or target markets is a key concern in selecting a distribution system and channels because the insurer's fixed costs of establishing an exclusive agent or direct-writer agent in a territory are substantial. Exclusive agent or direct writer marketing systems can be successful only when a sufficient number of prospects exist within a relatively small geographic area.

Because the cost of appointing an independent agent or using the direct response system is generally lower than the cost of appointing an exclusive or direct-writer agent, those systems can be used in sparsely populated areas or when the target market customers are widely dispersed. Some insurers that traditionally used either the exclusive agency system or the direct writer system have elected to use the independent agency system in rural areas and small towns because of the lower startup costs.

Degree of Control Required

The extent of control the insurer wants to exercise over its marketing operations may influence its choice of a distribution system:

- An insurer can exercise the greatest control over producers in the direct writer system. Under that system, the producer is an employee of the company, and the company can exercise control over both the results achieved and the methods used to achieve them. For example, an insurer can specify the number and type of new applications the producer must submit each month (results) as well as the marketing approaches the producer can use (methods).
- Under both the agency and brokerage system and the exclusive agency system, the producers are independent contractors; therefore, the insurer can control only the results they produce, not the methods by which they produce them. For example, an insurer can specify the number and type of new applications the producer must submit each month (results). However, the agent or broker can engage in any advertising or marketing

campaign to achieve those results that do not violate insurance regulations or contractual agreements with the insurer.
- Producers are not involved in the direct response system. Consequently, the insurer has complete control of its distribution system.

Degree of control becomes important in meeting the needs of some customers. For example, pharmaceutical manufacturers require specialized risk management advice that includes a risk control recovery plan following the release of a tainted drug or defective medical device to the public. The insurer may wish to control the nature of the risk management alternatives recommended to those insureds that foster transparency and immediate response following products liability losses.

Other insurers value discretion in the producers who represent them. For example, an insurer that specializes in church insurance or distributes insurance through religious affinity groups will expect to have some control over the producers' use of social media (Web-based sites used to exchange content with selected or broad audiences through the Internet). A producer's indiscretions posted in public forums can cause an insurer to lose accounts. Therefore, the insurer might choose a direct writer distribution system under which producers are employees and subject to the insurer's guidelines for media use.

HOW STATES REGULATE INSURANCE MARKETING ACTIVITIES

From the time of their formation, insurers are subject to state insurance regulation.

While the review processes for insurer licensing vary by state, all states require property-casualty insurers to receive approval before operating within the state. Just as departments of insurance (DOIs) have the authority to regulate insurers and related entities, state laws also give them the authority to regulate insurance producers, claim representatives, and other insurance personnel. The compensation of insurance producers includes commissions and salaries. Insurance producers must meet specific requirements to obtain and maintain a license in the state(s) in which they transact business. States prohibit unfair trade practices such as misrepresentation and false advertising, tie-in sales, rebating, and other deceptive practices.

Licensing

To function legally as an insurance agent, a producer must be licensed by the state(s) in which he or she wants to sell insurance. Some states issue separate licenses for agents, brokers, and solicitors. The titles and the authority associated with these licenses vary by state. Generally, insurance agents are defined legally as representatives of the insurer(s) for which they sell insurance. Brokers are representatives of the insurance purchaser rather than of the insurer.

Some states have separate licenses for solicitors, who work for and are representatives of agents or brokers, often as office employees, but who have less authority than agents. Generally, solicitors can solicit prospects but cannot bind insurance coverage. In other states, such office employees who solicit insurance must secure an agent's license; they are often called customer service representatives (CSRs) or customer service agents (CSAs).

To obtain a state insurance agent's license, a candidate generally must pass an examination on insurance principles, insurance coverages, and insurance laws and regulations. Some states require candidates to accumulate a minimum number of hours of classroom study before taking this examination. In some states, completing a recognized professional designation program allows the candidate to waive the classroom and examination requirements. Once a state agent's license has been issued, the agent must seek to be appointed by one or more insurers before he or she can sell insurance.

Producers' licenses generally have a specified term, such as one or two years, and can be renewed by paying a fee specified by the state. Most states also require producers to provide evidence that they have completed approved continuing education courses before the state will renew their licenses. Licensed producers are required to adhere to all laws regulating insurance sales in the state(s) in which they conduct business. The state can suspend or revoke licenses under certain circumstances, such as engaging in unfair trade practices.

Insurers

By issuing a license to an insurer, a state indicates that the insurer meets minimum standards of financial strength, competence, and integrity and that it has complied with the state's insurance laws and is authorized to write certain types of insurance. Once licensed, the insurer is subject to all applicable state laws, rules, and regulations. See the exhibit "Insurer Licensing Standards."

Insurer Licensing Standards

- Domestic insurers—If a domestic insurer obtains licenses in states other than its state of domicile, it is a foreign insurer in those other states. A domestic insurer's license generally has no expiration date. Domestic insurers usually must meet the conditions imposed on corporations engaged in noninsurance activities as well as some special conditions imposed on insurers. An applicant for an insurer license must apply for a charter. The state insurance commissioner reviews the application to see whether the applicant also meets the state's licensing requirements. An insurer must be financially sound.
- Foreign insurers—To be licensed in an additional state, a foreign insurer must show that it has satisfied the requirements imposed by its home state and generally must satisfy the minimum capital, surplus, and other requirements imposed on the state's domestic insurers.
- Alien insurers—Alien insurers must satisfy the requirements imposed on domestic insurers by the state in which they want to be licensed. Additionally, they must usually establish a branch office in any state and have funds on deposit in the United States equal to the minimum capital and surplus required.
- Nonadmitted insurers—A nonadmitted insurer is typically a surplus lines insurer. Under surplus lines laws, a nonadmitted insurer might be permitted to transact business through a specially licensed surplus lines producer if the insurance is not readily available from admitted insurers, the nonadmitted insurer is "acceptable," and the producer has a special license authorizing him or her to place such insurance. The surplus lines producer usually must be a resident of the state. An "acceptable" nonadmitted insurer generally must file a financial statement that the insurance commissioner finds satisfactory; supply documentation of transactions to state regulators; obtain a certificate of compliance from its home state or country; and, if an alien insurer, maintain a trust fund in the U.S.
- Risk retention groups—Risk retention groups are often formed under state captive laws, which generally maintain lower capital and surplus requirements for captives than for traditional property-casualty insurers. Once licensed as a commercial liability insurer under the laws of at least one state, a risk retention group can write insurance in other states without a license by filing the appropriate notice and registration forms with the nonchartering state. A risk retention group can write only commercial liability insurance for its members and may not write other lines of business. However, in a nonchartering state, a risk retention group might be subject to some state laws, such as unfair claim settlement practice laws, and to premium taxes. The risk retention group might also be required to become a member of a joint underwriting association (JUA) or a similar association.

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Insurance Personnel

In addition to licensing insurers, state regulators also license some categories of insurance personnel. States license many of the people who sell insurance, give insurance advice, or represent insurers, including producers, claim representatives, and insurance consultants.

- Producers—Producers must be licensed in each state where they do business. To obtain a license to sell a particular type of insurance, a producer must pass a written examination. Insurance producers operating without a license are subject to civil, and sometimes criminal, penalties.
- Claim representatives—Some states require claim representatives to be licensed so that those who make claim decisions for insurers are aware of prohibited claim practices, have a minimum level of technical knowledge and skill, and understand how to handle insureds' claims fairly. Licensing of claim representatives in most states includes an examination. The licensing process also typically involves a background check, as well as ethics requirements, to help protect consumers who file claims from unfair, unethical, and dishonest claim practices. Public adjusters, who represent insureds for a fee, are generally required to be licensed to ensure technical competence and to protect the public.
- Insurance consultants—Insurance consultants give advice about insurance policies. Some states require insurance consultants to be licensed, and requirements for a consultant's license vary by state. Separate examinations are usually required to be an insurance consultant in both life-health insurance and property-casualty insurance.

Compensation

The compensation of insurance producers includes sales commissions, contingent commissions, and salaries. Commissions, particularly contingent commissions, present potential conflicts of interest among insurers, producers, brokers, and insureds. Recent controversies related to insurer compensation have resulted in greater state scrutiny of practices related to commissions.

Sales Commissions

Commission

A percentage of the premium that the insurer pays to the agency or producer for new policies sold or existing policies renewed.

An independent agency or an exclusive agency receives **commissions** from the insurer for all insurance premiums the agency generates. An insurance broker may receive a sales commission or fee directly from the insurer or may receive a portion of the commission from the agent who placed the insurance. Commission rates vary by type of insurance. For example, the rate may be relatively low (such as 2 percent) for large workers compensation accounts and be at their highest (often 30 percent) for bonds. To keep premiums competitive, the rates for preferred types of policies may be lower than for standard or specialty products. Commission rates can also vary by agency.

For insurance agents, the method of premium collection determines how sales commissions are received. If the insurer handles billings and collections (direct billing), the insurer periodically mails a commission check to the agency. If the agency collects the premiums (agency billing or producer billing), it subtracts its commission on each policy and remits the balance of collected premiums to the insurer, usually monthly.

In a small agency with only one agent, the entire commission goes to that agent. In a larger agency, a portion of the commission typically goes to the producer who made the sale, and the remainder goes to the agency to cover other expenses.

Usually, commissions are not fully earned at the time of a sale. If policies are canceled or premiums are returned to an insured for some other reason (such as deleting or reducing coverage), the producer must also return the unearned portion of the commission to the insurer. The commission compensates the agency not only for making the sale but also for providing service before and after the sale.

A producer who is an employee of a direct writer insurer generally receives a salary and perhaps a bonus commensurate with the premiums of the policies the producer sells. The compensation arrangements of direct writer insurers tend to emphasize sales to new customers.

Contingent Commissions

Insurers sometimes provide **contingent commission agreements** as a form of incentive compensation for producers who exceed established benchmarks for profitability and volume of business. The insurer compares the premiums received for policies sold by the agency with the losses incurred under those policies to determine whether the agency's business has earned a profit. If the business sold by the agency attains a certain volume of premium and level of profitability, the insurer shares a portion of the profit with the agency. For agencies that provide insurers with a steady stream of business, contingent commissions can provide up to 10 percent or more of total agency revenues.

Contingent commission agreement

A contract provision in which an insurer agrees to make supplemental payments to producers based on profitability alone or on a combination of profitability, volume, and growth in the agency's book of business placed with that insurer.

Contingent commissions encourage agencies to sell only policies that will be profitable for the insurer. Agencies that practice careful selection can earn sizable contingent commissions as a result. However, over the last several years, contingent commissions have attracted greater regulatory scrutiny, as they can provide an incentive for a producer to direct business to insurers based on the level of commission received from the insurer as opposed to basing placement strictly on the best interests of the insured. A prominent scandal associated with this conflict of interests occurred in 2004, when New York Attorney General Eliot Spitzer accused a large insurance broker of directing business to insurers based on excessive contingent commissions and kickbacks. Similar scandals in other states have led to calls for the abolition of contingent commissions altogether and to the contemplation of state laws that would require producers to disclose information related to their compensation to clients. One such law enacted in 2011, New York's Insurance Regulation 194, "Producer Compensation Transparency," requires producers licensed in New York to offer unrequested information about their compensation to their clients.[1]

SUMMARY

The legal relationship of agency empowers the insurance producer—the agent—to act on behalf of the insurer—the principal. An agent's authority can be either actual or apparent. An agent's actual authority can be express or implied. Binding authority, generally granted to the agent in the agency contract, is a form of express authority. Apparent authority generally occurs when a principal grants less authority than agents usually have, or when the principal's business operates differently from similar businesses in the area.

Insurance distribution systems consist of the necessary people and physical facilities to support the sale of insurance products and services. The main insurance distribution systems are these:

- Independent agency and brokerage marketing system
- Exclusive agency marketing system
- Direct writer marketing system

Insurers use distribution channels to promote products and services as well as to communicate with existing and prospective insureds.

Insurance producers represent one or more insurance companies and perform these typical functions:

- Prospecting
- Risk management review
- Sales
- Policy issuance
- Premium collection
- Customer service
- Claim handling
- Consulting

Insurers should evaluate various factors when selecting distribution systems and channels. These factors include customers' needs and characteristics, such as the products and services they require, the price they are willing to pay, and the response time they require.

Insurers' profiles serve as guidelines that affect their choice of distribution systems and channels. Insurers' profiles include their strategies and goals, strengths, existing and target markets, geographic location, and the degree of control required.

Producer regulation occurs primarily through agent and broker licensing laws and other state laws dealing with insurance, such as unfair trade practices laws. Insurance regulators govern the formation and licensing of insurers and the licensing of insurance personnel. By issuing a license to an insurer, a state indicates that the insurer meets minimum standards of competence, integrity, and financial strength. States also license many of the people who sell insurance, give insurance advice, or represent insurers, including producers, claim representatives, and insurance consultants.

ASSIGNMENT NOTE

1. Tim Dodge, "Producer Compensation Disclosure: What You Need to Know," January 2011, www.propertycasualty360.com/2011/01/26/producer-compensation-disclosure (accessed April 14, 2011).