Segment B: Insurance Operations

Segment A presented the fundamentals of insurance and information about the insurers who provide it. This segment discusses the major operations of those insurers: marketing, underwriting, and claims.

Chapter 4

Marketing

Educational Objectives

After studying this chapter, you should be able to:

1. Explain the legal relationship known as agency. (pp. 4-3 to 4-4)
2. Identify and describe the duties of each of the following in any agency relationship: (pp. 4-4 to 4-6)
   a. The agent
   b. The principal
3. Describe each of the following types of insurance agents' authority: (pp. 4-6 to 4-9)
   a. Express authority
   b. Implied authority
   c. Apparent authority
4. Describe and distinguish among the various types of insurance marketing (or distribution) systems. (pp. 4-9 to 4-15)
5. Describe typical compensation arrangements for insurance producers. (pp. 4-15 to 4-17)
6. Describe advertising methods used by various insurers, producers, and producer trade associations. (pp. 4-17 to 4-18)
7. Describe the various aspects of marketing management. (pp. 4-18 to 4-20)

8. Describe ways in which states regulate producers' activities. (pp. 4-20 to 4-24)
9. Identify and describe acts related to insurance that are considered unfair trade practices in most states. (pp. 4-22 to 4-24)
10. Define or describe each of the Key Words and Phrases for this assignment. (All Key Words and Phrases appear in bold print in the text and in boxes in the margins throughout this chapter.)

Chapter 4

Marketing

Marketing enables an insurance company to determine which products meet consumers' needs and then to sell and deliver those products to its customers. An insurer might have the best product at the best price available, but if consumers are not aware of this fact, the insurer will sell few, if any, policies. Consumers have many different insurance needs. One insurance company might attempt to fill only a few of those needs; another might attempt to meet a wide range of insurance needs.

Marketing is the process of identifying customers and their needs and then creating, pricing, promoting, selling, and distributing products or services to meet those needs.

Insurance marketing does not stop after the consumer buys the product. People involved in insurance marketing also assist consumers in their dealings with the insurance company after a policy is issued. Insurance companies depend on their marketing personnel to keep them informed about the changing needs and desires of the insurance-buying public.

Many insurance marketing systems exist and most involve a salesperson of some kind. Various terms, such as agent, broker, producer, solicitor, or sales representative, are used to refer to this salesperson. This book uses the term **producer** to refer to any person who sells insurance (produces business) for an insurance company or companies; however, "agent," "broker," "sales representative," and other titles are also used here to denote special categories of producers.

A **producer** is any person who sells insurance products for an insurance company or companies.

Educational Objective 1

Explain the legal relationship known as agency.

The Legal Role of the Insurance Agent

Agency is a legal relationship that is formed when one party, the *principal*, authorizes another party, the *agent*, to act as a legal representative of the principal.

In the agency relationship, the **principal** is the party that authorizes the agent to act on its behalf.

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

The legal relationship known as "agency" is not limited to insurance but exists in many situations. An **agency** exists whenever one party, the **agent**, represents or acts on behalf of another party, the **principal**. The principal gives authority to the agent to act as its representative within certain guidelines. The principal may authorize the agent to do anything the principal can do. For example, an insurance company (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 insurance company within a certain amount of time.

The agency relationship requires a high degree of mutual trust between the principal and the agent, since it imposes far-reaching 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.

Creation of the Agency Relationship

Insurance agents are legal representatives of the insurance company or companies for which they have contractual agreements to sell insurance.

In insurance, an **agency contract**, or **agency agreement**, is a written agreement between an insurance company and an agent that specifies, among other things, the scope of the agent's authority to conduct business for the insurer.

An agency relationship is usually created by a written contract between the principal and the agent. In insurance, the insurance company is the principal that appoints **insurance agents** to serve as its representatives; a written agency contract specifying the scope of authority given to an agent formalizes this relationship. An **agency contract**, also known as an **agency agreement**, gives the agent the right to represent the insurer and to sell insurance on the insurer's behalf. The contract states the compensation arrangement between the insurer and the agent. The agency contract also specifies 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 as required by the contract.

Educational Objective 2

Identify and describe the duties of each of the following in any agency relationship:

a. The agent
b. The principal

Responsibilities of the Agent and the Principal

The agency relationship, which is based on mutual trust and confidence, empowers the agent to act on behalf of the principal and imposes significant responsibilities on both parties.

Responsibilities of the Agent to the Principal

In an agency relationship, the agent's fundamental responsibility is to act for the benefit of the principal. The laws of agency impose five specific duties on all agents, including insurance agents:

- Loyalty
- Obedience
- Reasonable care
- Accounting
- Relaying information

Two of the agent's most important duties are to be loyal to the principal and to obey the principal's lawful instructions. In addition, an agent must exercise a reasonable degree of care in its actions on behalf of the principal; in other words, the agent must act as a reasonably prudent person would under the same or similar circumstances. Under the duty of accounting, the agent is responsible to the principal for all the principal's money and property that comes into the agent's possession; the agent must account promptly for any of the principal's money that the agent holds. The duty of relaying information requires the agent to keep the principal informed of all facts relating to the agency relationship.

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 insurance company according to the terms of the agency contract.

Responsibilities of the Principal to the Agent

Just as the agent owes duties to the principal, so the principal legally owes certain duties to the agent. The principal's primary duty is to pay the agent for the services performed. In the case of an insurance agent, this duty entails payment by the insurer of 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 acts 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 the agent if the agent acts illegally or without the principal's authorization, even though the principal might 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 might arise from the 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 because of the agent's poor advice. For further information on errors and omissions issues, the Insurance Institute of America's Accredited Adviser in Insurance (AAI) program, designed for insurance producers, provides tips on avoiding E&O claims.

Errors and omissions (E&O) are negligent acts (errors) committed by a person in the conduct of the insurance business that give rise to legal liability for damages. E&O claims can also arise from a failure to act (omission) that creates legal liability.

Responsibilities of the Agent and the Principal to Third Parties

An agency relationship also creates responsibilities to third parties (parties other than the agent and the principal). The agent's authorized acts on behalf of the principal legally obligate the principal to third parties in the same way as if the principal acted alone. Thus, from an insured's point of view, little distinction exists between the insurance agent and the insurance company.

Since the agent represents the insurance company, the law presumes that knowledge acquired by the agent is knowledge acquired by the insurance company. 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 insurance company 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 presumed to know about it.

Educational Objective 3

Describe each of the following types of insurance agents' authority:

a. Express authority
b. Implied authority
c. Apparent authority

Authority of Agents

The principal is legally bound by any acts of the agent that are within the agent's authority. Insurance agents generally have three types of authority to transact business on behalf of insurers that they represent:

- Express authority
- Implied authority
- Apparent authority

Express Authority

The terms of the agency contract define the **express authority** of the agent. For example, the contract will state that the agent has authority to sell the insurance company's products or that the agent has authority to bind coverage up to a specified limit.

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

Binding authority is generally granted to the agent in the agency contract and, thus, is a form of express authority. Binding authority is the power to make insurance coverage effective on behalf of the insurer; binding coverage is usually accomplished by issuing binders. A **binder,** which can be either written or oral, is a temporary contract between the insurance company and the insured that makes insurance coverage effective.

Binding authority, which is usually granted in the agency contract, is the authority of an insurance agent to effect coverage on behalf of a particular insurer.

A **binder** is a temporary contract of insurance and can be either written or oral.

For example, suppose Christopher owns an old car for which he has an automobile policy with no collision coverage. Christopher purchases a new car and telephones his insurance agent, Lisa, to make sure the car is covered before he drives it away from 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 have a policy change (called an endorsement) issued 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.

As illustrated by the example, oral binders are often used until the paperwork necessary to have an endorsement or a new policy issued is completed. Such paperwork often includes a written binder completed on a standard form. A written binder provides a brief summary of who is insured, what is insured, and the coverages and limits that apply.

Binding authority gives an agent the power to put specified types and limits of coverage in force at once rather than waiting for approval from the insurer. When 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.

Implied Authority

Implied authority is authority that arises from actions of the agent that are in accord with accepted custom and that are considered to be within the scope of authority granted by the principal, even though such authority is not expressly granted orally or in an agency contract.

The scope of an agent's authority, however, can go beyond the terms of the agency contract. In addition to express authority, the agent may have **implied authority** to perform other tasks necessary to accomplish the purpose of the agency relationship. For example, assume that IIA Insurance Company's agency contract with Dutie Insurance Agency does not give Dutie's agents express authority to collect premiums from IIA's insureds. Dutie's agents would have implied authority to do so because collecting premiums is an act that is reasonably necessary for Dutie to accomplish the sale of IIA's policies, and the sale of IIA's policies is expressly authorized in the contract.

Apparent Authority

Apparent authority is authority based on a third party's reasonable belief that an agent has authority to act on behalf of the principal.

An agent can also have **apparent authority** to act on behalf of the principal in ways that the principal does not intend. Usually, an insurance agent has broadly defined powers to represent an insurance company and to transact the company's business. Without actual notice or reason to believe otherwise, a third party cannot be expected to know of any unusual limitations on the agent's authority. The insurance company is bound by all acts within the agent's apparent authority, unless the insurer takes steps to prevent that outcome.

For example, IIA Insurance Company furnishes its agents with application forms showing the IIA name and logo. IIA grants its agents binding authority for routine applications for homeowners Insurance. If IIA terminates its agency agreement with Greene Insurance Agency but fails to retrieve the blank application forms, a Greene producer might inadvertently take Maria's application for homeowners insurance on an IIA application form, accept Maria's check for the premium, and tell her that her coverage is bound effective that day. If a fire occurs in Maria's house the next day, IIA Insurance Company would probably be required to pay the claim because it appeared to Maria that the Greene Insurance Agency had the authority to bind her coverage with IIA. From Maria's standpoint, the Greene Insurance Agency *apparently* had the authority to bind coverage for IIA. Maria would not be penalized because she did not know that IIA had terminated its agency contract with the

Greene Insurance Agency. IIA, however, might attempt to recover the cost of the claim from Greene.

Educational Objective 4

Describe and distinguish among the various types of insurance marketing (or distribution) systems.

Insurance Marketing Systems

Insurance companies have many types of marketing systems, also known as distribution systems, designed to meet their particular marketing objectives. Most insurers use one or more of the following traditional marketing systems:

- Independent agency system
- Exclusive agency system
- Direct writing system
- Direct response system

Exhibit 4-1 shows some of the differences among these traditional insurance marketing systems. These marketing systems are not mutually exclusive. Some insurance companies use a mixed marketing system, combining two or more of these traditional distribution systems. In fact, combinations of distribution systems are becoming increasingly common among insurers.

Independent Agency System

The independent agency system is used by insurance companies of all sizes. When an insurance company uses the independent agency system, insurance sales are made through independent insurance agents. An **independent agency** is a business, operated for the benefit of its owner or owners, that sells insurance, usually as a representative of several unrelated insurers. The agency can be organized as a sole proprietorship (owned by an individual), a partnership (owned by two or more individuals), or a corporation (owned by stockholders). Closely related to and often working with independent agencies are brokers and managing general agencies.

An **independent agency** is an independent firm that sells insurance, usually as a representative of several unrelated insurance companies.

Independent Agents

An **independent agent** is a producer who works for an independent agency and can be either the owner or an employee of the agency. In a small independent agency operated by a sole proprietor who is the only producer, the independent agent and

An **independent agent** is a producer who works for an independent agency.

Exhibit 4-1
Differences Among Traditional Insurance Marketing Systems

Type of marketing (or distribution) system	What company or companies do the producers represent?	Are the producers employed by the insurer?	How are producers usually compensated?	Does the agency or agent own the expiration list(s)?	What methods of sales are usually used?
Independent agency system	Usually more than one insurer	No, the producers are employed by the agency	Sales commissions and contingent commissions	Usually, yes	Personal contact, phone, or Internet
Exclusive agency system	Only one insurer or group of related insurers	Usually, no; however, some producers begin as employees	Sales commissions (commissions on renewals might be lower than on new business) and bonus	Usually, no; but the agency contract might provide for the agent's right to sell the list to the insurer	Personal contact, phone, or Internet
Direct writing system	Only the producers' employer	Yes	Salary, bonus, commissions, or combination	No	Personal contact, phone, or Internet
Direct response system	Only the producers' employer	Yes	Salary	No	Mail, phone, or Internet

the independent agency are the same. Larger independent agencies are usually corporations that employ many producers. Independent agencies enter into agency contracts with one or more insurance companies.

An **agency expiration list** is the record of an insurance agency's present policyholders and the dates their policies expire. "Owning the expirations" means that the agency expiration list of an independent agency belongs to the agency (not the insurer) and gives the agency the right to solicit those policyholders for insurance.

One of the main distinguishing features between independent agency systems and other marketing systems is the ownership of the **agency expiration list**, which is the record of present policyholders and the dates their policies expire. The typical independent agency contract specifies that the independent agency—not the insurance company—owns the list of policyholders, the dates their existing policies expire, and, most importantly, *the right to solicit these policyholders for insurance*. If the insurance company ceases to do business with a particular agency, the insurance company cannot legally sell insurance to the agency's customers or give the expiration list, showing policyholders with that agency, to another agency. Under such circumstances, the independent agency has the right to continue doing business with its existing customers by selling them insurance with another insurance company. The customers, however, are not obligated to keep their business with the agency, but might choose another agency or company.

Because of the independent agency's traditional exclusive right to solicit policyholders on an agency expiration list, the ownership of expiration lists is generally considered the agency's most valuable asset when an independent agency is bought or sold. The agency has the right to sell its expiration lists to another independent agent. For example, if the agency were to be sold, the new buyer would want to keep the agency's customers and would thus want the agency's expiration lists.

Sometimes, an independent agent determines that a different insurance company represented by the agency can better meet an existing customer's needs. Occasionally, an insurance company might be unwilling to renew an insurance policy or might have rates that are not competitive. Therefore, the agent must select another insurer for the customer. In either case, the independent agency has the right to switch the coverage to another insurer, subject to the customer's approval.

Exceptions to the General Rule: Independent Agencies That Represent Only One Insurer

Independent insurance agencies generally represent more than one, and sometimes a dozen or more, insurance companies. However, it would not be accurate to state that all independent agencies represent more than one insurance company. Some independent agencies represent only one insurer or a group of related insurers. An agency might not find it practical to represent more than one insurer because the agency is small or just starting in business, the agency might specialize in one type of coverage, or the agency might have a special arrangement with an insurer.

Some independent agents agree to place all or most of their business with just one insurance company. Agents find some advantages in doing a large volume of business with one insurance company rather than a smaller volume with each of several companies. Some insurance companies offer independent agents incentives for special agency agreements. Those incentives might include computer systems, higher commission rates, a more open market for the agent's customers, or other advantages.

Brokers

An insurance **broker** is an independent business owner or firm that represents customers rather than insurers. Brokers shop among insurance companies to find the best coverage or value for their clients—the insurance buyers. Some insurance companies require that brokers purchase insurance through one of the company's agents who, in turn, pays a portion of the agent's commission to the broker. Other insurance companies have contracts with and regularly accept business directly from

An insurance **broker** is an independent business owner or firm that sells insurance by representing customers rather than insurers.

insurance brokers and pay them a fee or commission for the business. Since they are not legal representatives of the insurer, brokers are not likely to have authority to commit the insurer by binding coverage, unlike agents, who generally have binding authority. As discussed in Chapter 2, an excess and surplus lines (E&S) broker is a special type of broker who is licensed by a state or states to transact insurance through nonadmitted insurers.

In practice, despite the technical distinctions between brokers and independent agents, the differences are quite limited. Both brokers and independent agents are intermediaries between insurance companies and insurance buyers, and both collect premiums from insureds and remit them to insurers. Both are in the business of finding people with insurance needs and selling insurance appropriate to those needs. In fact, the same person can act as an agent on one transaction and as a broker on another. A person acts as an agent when placing insurance with an insurer for which he or she is licensed as an agent but might act as a broker when placing insurance with other agents or insurers.

Large brokerage firms have many brokers who generally handle commercial insurance accounts that often require sophisticated knowledge and service. Many brokerage firms operate nationally, with offices in many states, and some operate internationally as well. In addition to insurance sales, large brokerage firms, as well as large agencies, might provide extensive loss control, appraisal, actuarial, risk management, and other insurance-related services that large businesses need. A few large brokerage firms account for a substantial share of the commercial property and liability insurance sold in the United States.

A **managing general agency** (**MGA**) is an independent business organization that appoints and supervises independent agents for insurance companies that use the independent agency system. The MGA functions almost as a branch office for one or more insurance companies.

Managing General Agencies (MGAs)

A **managing general agency** (**MGA**) is an independent business organization that functions almost as a branch office for one or more insurance companies. The MGA appoints and supervises independent agents for insurance companies that use the independent agency system. MGAs serve as intermediaries between insurers and agents who sell insurance directly to the consumer, in much the same position as wholesalers in the distribution system for tangible goods. The exact duties and responsibilities of an MGA depend on its contracts with the insurers it represents. The MGA receives a managerial commission—often referred to as an "override"—which is a percentage of the premium or the profits on policies sold by producers placing business with the insurance company through the MGA.

Excess and surplus lines brokers resemble MGAs in that they usually transact business primarily with other brokers and agents and not directly with consumers. In fact, some firms operate as both MGAs and E&S brokers.

Exclusive Agency System

An **exclusive agent** resembles an independent agent in some ways. Like the independent agent, the exclusive agent's business operation is his or her own insurance sales agency. An agency agreement describes the exclusive agent's binding authority and compensation arrangements.

An **exclusive agent** is an agent that has a contract to sell insurance exclusively for one insurance company (or a group of related companies).

Unlike the agency agreement in the independent agency system, the exclusive agency system limits the agent to selling insurance *exclusively for one insurance company* or group of related companies. If a desired type of insurance is not written by the insurance company represented, some contracts allow the agent to place ("broker") the business with an independent agent or another exclusive agent.

Generally, an exclusive agent is not an employee of the insurance company but a self-employed representative of the company. With some exclusive agency insurance companies, agent trainees begin as employees and later make the transition to owning their own business.

Some exclusive agency contracts provide that the agent owns the agency expiration list and has the right to sell it to another party, but this is often not the case. Usually, the contract contains an agreement that, upon termination of the agency contract, the insurance company will buy the expiration list from the exclusive agent, using a predetermined formula to establish its value. An exclusive agent's expiration list—and the right to consider people on the list as customers *of that agent*—can become a valuable asset as an exclusive agent's business grows.

Direct Writing System

As with the exclusive agency system, producers in the **direct writing system** sell insurance for only one insurance company or group. Unlike most producers in the exclusive agency system, however, producers in the direct writing system are not self-employed. They are employees of the insurance company, and their job is to sell insurance for the company. Employees who work as insurance producers for a **direct writer** are generally called sales representatives. Terminology can be confusing here. A direct writer's sales representatives are sometimes called agents, and they must possess agents' licenses. Legally, they function as agents of the insurance company, and most insurance buyers would not distinguish between an agent and a sales representative.

The **direct writing system** of insurance marketing uses sales representatives who are employees of an insurance company.

A **direct writer** is an insurer that uses the direct writing system to market insurance.

Like employees in general, a direct writer's sales representatives work from offices or other business locations provided by the employer. The insurance company in this system, unlike insurers using the independent and exclusive agency systems, pays the office expenses as well. Employees can be transferred from job to job and from office to office to meet the overall needs of the insurer.

Because the direct writer's sales representative is an employee of the insurance company, the expiration list belongs not to the sales representative but to the insurance company, which can use the customer information as a source of prospects for follow-up sales by its other sales representatives.

Brokering Business

Sometimes an agent has a customer who needs a type of policy not available from an insurance company the agent represents. When this happens, the agent might contact an agent who represents another insurance company and apply for insurance through that agent. The agent who represents the insurer usually shares the commission with the agent who has the customer.

In this situation, the original agent acts as a broker—the agent shops for insurance on behalf of the customer. The act of placing the insurance for this customer through another agent is called *brokering*. The insurance sold in this manner is referred to as *brokered business*.

Exclusive agents and direct writers' sales representatives, as well as independent agents, might occasionally broker business for an account whose other coverages are handled by the producer's insurance company. Authority for such transactions would be specified in the agency or employment contract.

Direct Response System

The **direct response system** includes any insurance marketing system that does not depend primarily on individual producers to locate customers and sell insurance but relies primarily on mail, phone, and/or Internet sales.

The **direct response system** includes any insurance marketing system that does not depend primarily on individual producers to locate customers and sell insurance. Direct response insurance companies advertise directly by mail, radio, television, Internet, or with the communications of an association, a credit card company, or a bank. These advertisements encourage potential customers to contact the insurance company to purchase insurance.

With this system, a person shopping for insurance coverage contacts the insurance company by telephone, through the mail, or on the Internet. An employee of the insurance company, often called a customer service representative (or CSR), handles the telephone call or correspondence. The CSR could be in an office hundreds of miles away from the customer.

Mixed Marketing System

Traditionally, each insurance company used just one of the marketing systems described above. Recently, many insurance companies have departed from this practice. The term **mixed marketing system** refers to an insurance company's use of more than one distribution system. This practice, which has become increasingly popular among insurers, is also referred to as using alternative distribution systems.

A **mixed marketing system** refers to the use by an insurer of more than one marketing system.

For example, some insurers that traditionally sold insurance only through independent agents have also done some direct response marketing, developing business without producers and without paying commissions to producers. These insurance companies generally argue that advertisements and direct mail enable them to reach customers they would not reach through an independent agent. Nevertheless, the company's independent agents sometimes feel they are being bypassed by such practices.

Conversely, some direct writers, seeking to expand their business, have entered into agency agreements with independent agents in some areas. These direct writers have turned to independent agents as a distribution system partly because they have found it relatively expensive to establish offices and develop trained employees—especially in small communities.

Educational Objective 5

Describe typical compensation arrangements for insurance producers.

Compensation of Producers

While some producers receive a salary, commissions provide the primary form of compensation for producers. Two types of commissions that producers typically earn are sales commissions and contingent commissions.

Sales Commissions

An independent agency or an exclusive agency receives commissions from the insurer for all insurance premiums the agency generates. A **sales commission** (or simply, a **commission**) is a percentage of the premium that goes to the agency or to the producer. As mentioned, an insurance broker might receive a sales commission or fee directly from the insurer or might receive a portion of the commission from the agent who placed the insurance.

A **sales commission** (or simply, a **commission**) is a percentage of the premium that the insurer pays to the agency or producer for new policies sold or existing policies renewed.

For insurance agents, the method of premium collection determines how sales commissions are received. If the insurance company handles billings and collections (direct billing), the insurance company 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 insurance company, usually on a monthly basis.

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 premium is 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 insurance company.

The commission compensates the agency not only for making the sale but also for providing service before and after the sale. Service provided before the sale includes locating and screening insurance prospects, conducting a successful sales solicitation, getting the necessary information to complete an application, preparing a submission to the insurance company, and presenting a proposal or quote to the prospect. To make a sale, the agent must also evaluate a prospect's insurance needs and recommend appropriate coverages for the client to select. After the sale, the agency often handles the paperwork that accompanies policy changes, billing, and claim handling, among other things. When it is time for the policy to be renewed, the agency must again analyze coverage needs and consider any changes in insurance coverage that have become available.

The producer who is an employee of a direct writer generally receives a salary and perhaps also a bonus that relates to the premiums of the policies the producer sells. The compensation arrangements of direct writers tend to emphasize sales to new customers, since these companies generally assign service after the sale to employees who specialize in the applicable areas, such as claims. With some insurers, drive-in claim service offices and other customer service centers handle most of the services required after the sale, including policy changes and billing problems.

Contingent Commissions

A **contingent commission** is a commission that an insurer pays, usually annually, to an independent agency and that is based on the premium volume and profitability level of the agency's business with that insurer.

In addition to commissions based on a percentage of premiums, many agencies receive a **contingent commission**, sometimes referred to as "profit sharing." The insurance company 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 company shares a portion of the profit with the agency. Since this extra commission is *contingent* on earning a profit, it is called a contingent commission. Contingent commissions encourage agencies to sell policies that will be profitable to the insurance company and to avoid selling policies that are likely to be unprofitable. Agencies that practice careful selection can earn sizable contingent commissions as a result. An independent agency is typically eligible to receive a contingent commission annually from each insurer for which the agency's business has been profitable.

Insurance companies that use the exclusive agency system or the direct writing system might offer higher sales commissions, rather than contingent commissions, for agents whose sales generate a given level of profit. Alternatively, these companies sometimes offer bonuses or other forms of compensation to agents whose business is profitable.

Educational Objective 6

Describe advertising methods used by various insurers, producers, and producer trade associations.

Advertising

An independent agency attempts to attract customers *for the agency*, and local advertising often stresses the agency rather than the various insurers it represents. On the other hand, many insurance companies marketing through the independent agency system use national advertising programs intended to enhance the company image. With many products, "name brands"—those that are known and recognized—tend to be most readily accepted by customers. Insurance is no exception. Advertising symbols like the Travelers umbrella, the Hartford stag, and the Fireman's Fund fire helmet are designed to increase public recognition of these companies.

Local independent agents sometimes identify with national symbols or repeat nationally advertised slogans in their advertisements. At other times, their ads focus on the agency itself—its quality of service, reputation, personnel and their qualifications, range of services, or similar themes that might attract an insurance buyer.

In the exclusive agency system, advertising programs emphasize the names of both the insurance company and the agent. Sometimes an insurance company's advertisement lists all its agents in the area and includes a photo of each agent. Advertising for direct writers tends to emphasize the company itself rather than individual producers or office locations.

Since they do not have producers, insurers using direct response marketing must use other ways of attracting new customers.

Some insurers using the direct response system advertise heavily—an activity that can be quite costly. Others, working from an established customer base, have traditionally relied successfully on free word-of-mouth advertising.

In addition to the traditional types of advertising—television, radio, magazines, newspapers, mail, and so forth—insurers and agents of all types are increasingly using the Internet for advertising, and most insurers and many agents now have websites giving information about the company or agency and the products and services it provides.

Producers' 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 members of the associations as a group and to make the public familiar with the logo and other symbols of each association.

Independent Agents' Trade Associations

Most independent agents are members of the Independent Insurance Agents of America (IIAA) or the National Association of Professional Insurance Agents (PIA) or both. The IIAA is often called the "Big I" because of the prominent letter "*I*" in its advertising logo. (In some states, IIAA and PIA have consolidated to form one state insurance agents' association.)

Agents' and Brokers' Trade Association

The members of the Council of Insurance Agents and Brokers (CIAB) are independent agents and brokers associated with large agencies or brokerage firms that primarily handle commercial insurance.

Managing General Agents' Association

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.

Educational Objective 7

Describe the various aspects of marketing management.

Marketing Management

All insurance companies need some means of managing the activities of producers—systems to supervise producers, to motivate them, and to provide them with insurance products they can sell. An important function of marketing management is monitoring agency sales and underwriting results to ensure that both the company's and the agency's sales and profit objectives are met.

Producer Supervision

Although selling insurance is essentially a one-on-one activity that often occurs away from the producer's office and the insurer's home office, insurance companies do supervise their producers. An insurance company using independent agents typically has **marketing representatives** who visit the independent agents representing the company. The marketing representative's role is to develop and maintain a sound working relationship with the insurer's agents and to motivate the agents to produce a satisfactory volume of profitable business for the insurer. Marketing representatives also have the responsibility of finding and "appointing" (entering into agency contracts with) new independent agents who can potentially produce profitable business for the company. Some marketing representatives operate from their homes and spend most of their time traveling among agencies in their marketing territories, maintaining a close personal contact.

Marketing representatives are insurance company employees whose role is to visit agents representing the insurer, to develop and maintain sound working relationships with those agents, and to motivate the agents to produce a satisfactory volume of profitable business for the insurer.

Other insurance companies have **production underwriters**, who spend most of their time inside the insurance company office but also travel to maintain rapport with agents and to meet with clients in special situations. Insurers using the direct writing system might have an agency manager or district manager as the supervisor of a group of producers, directing their activities rather closely.

Production underwriters are insurance company employees who work in an insurer's office in an underwriting position but who also travel to visit and maintain rapport with agents and sometimes clients.

Depending on how an insurer is structured, producer supervision and support can be provided from either the insurer's home office or a branch office or regional office. Small insurers, or those doing business in a limited geographic area, might have only one office. When this is the case, producers deal directly with personnel in the home office.

Insurers doing business nationally or over a widespread geographic area usually find it desirable to establish field offices close to producers' offices, and producers usually work closely with a local field office rather than the home office. A small field office, perhaps with only one marketing manager or marketing representative, might be called a service office. A larger office, containing management personnel, underwriters, claim representatives, and others, might be called a branch office or a regional office.

Producer Motivation

Insurance companies need to motivate their producers to sell the types of insurance the companies want sold. This, too, is the task of insurance company marketing management. Some producer motivation results from personal relationships and encouragement by marketing representatives, regional managers, and other people working in field offices. Other motivation comes from programs developed in the home office.

The financial incentives that producers receive for selling can affect their sales performance. The insurance company's marketing department considers this motivational effect when recommending the amount of salaries, bonuses, or commissions to be paid to producers. Insurers often pay contingent commissions to reward producers for producing business that earns a profit for the insurer.

Some insurance companies develop sales contests to encourage some specific production activities, such as selling a particular type of policy or reaching a particular level of sales activity. Sales contests can lead to special recognition or to an all-expenses-paid trip to a resort for a combination of business and pleasure.

Product Management and Development

Insurance production is most successful when producers have a desirable product to sell at a competitive price. The insurance company's marketing department—usually at the home office level—strives to give producers the products and pricing they need. The home office marketing department bases many of its decisions on information provided by producers and by other insurance company personnel in the field. An insurer's product management involves maintaining an ongoing relationship with producers.

People involved with sales are often the first to identify a need that could be addressed by either a new policy or modification of an existing policy. Those involved in marketing are acutely aware of what the competition is doing in regard to product management and development. The response to new product development elsewhere is often critical to satisfying changing market demands.

The home office marketing department cooperates with other departments to determine what coverages the insurer's insurance policies should provide, what price to charge, and what other services the insurer should provide. Decisions in those matters are based partly on claim costs for the particular insurer or for the industry as a whole and on information about the coverages, prices, and services of competing insurers.

Educational Objective 8

Describe ways in which states regulate producers' activities.

Regulation of Insurance Producers

In addition to regulating insurer activities as discussed in Chapter 2, state insurance departments regulate activities of insurance producers. Such regulation occurs primarily through agent and broker licensing laws and other state laws dealing with insurance, such as unfair trade practices laws.

Licensing Laws

To function legally as an insurance agent, a producer must be licensed by the state or states in which he or she wishes to sell insurance. Producers' licensing laws vary by state and change periodically. Some states have several different licenses, including licenses for agents, brokers, and solicitors. The exact titles and the authority that goes with them vary somewhat by state. Generally, insurance agents are defined legally as representatives of the insurance company or companies for which they sell insurance. Brokers, as stated previously, are the representatives of the insurance purchasers rather than of the insurance companies with which they transact business. Some states, such as California, have separate licenses for "solicitors," who work for and are representatives of agents or brokers, often as office employees, and who have more limited 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 agent's license, a person must meet several requirements. Usually, a producer must pass an examination and meet other qualifications of the state insurance department to receive a state insurance license. These examinations typically deal with insurance principles, insurance coverages, and insurance laws and regulations. Some states mandate a certain number of hours of classroom study before a candidate can take a license examination. In some states, completing a recognized professional designation program, such as the Chartered Property Casualty Underwriter (CPCU) program, allows the producer to waive the classroom and examination requirements for licensing. Once a state agent's license has been issued, an agent generally must seek to be appointed by one or more insurance companies 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 impose a continuing education requirement, requiring that producers periodically complete a specified number of hours of educational study related to the insurance business. Producers in those states must 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 or states in which they conduct business. The state can suspend or revoke licenses under certain circumstances, such as engaging in unfair trade practices.

Educational Objective 9

Identify and describe acts related to insurance that are considered unfair trade practices in most states.

Unfair Trade Practices Laws

Unfair trade practices laws are state laws that specify certain prohibited business practices.

Many states have adopted **unfair trade practices laws** that specify certain prohibited practices. These laws are not specifically limited to the activities of insurance producers. Underwriters, claim representatives, and others could also be guilty of misconduct in these areas. Although they vary by state, these laws typically prohibit various unfair trade practices, such as:

- Misrepresentation and false advertising
- Tie-in sales
- Rebating
- Other deceptive practices

Misrepresentation and False Advertising

It is an unfair trade practice for insurance agents or other insurance personnel to make, issue, or circulate information that does any of the following:

- Misrepresents the benefits, advantages, conditions, or terms of any insurance policy
- Misrepresents the dividends to be received on any insurance policy
- Makes false or misleading statements about dividends previously paid on any insurance policy
- Uses a name or title of insurance policies that misrepresents the true nature of the policies

It is also considered an unfair trade practice to make untrue, deceptive, or misleading advertisements, announcements, or statements about insurance or about any person in the insurance business.

Tie-In Sales

It is an unfair trade practice for a producer to require that the purchase of insurance be tied to some other sale or financial arrangement—a practice referred to as a "tie-in sale." It is also an unfair trade practice for a lender to require that a borrower purchase insurance from the lender or from any insurer, agent, or broker recommended by the lender. Each transaction must stand on its own, and insurance on property that is the subject of a loan can be purchased from any insurer the borrower chooses.

For example, assume that Richard, a salesman with New Car Dealership also holds an insurance agent's license with White Insurance Company and sells insurance in addition to selling cars. If Julia purchases a car from Richard, Richard cannot require that Julia purchase insurance on the car from White Insurance Company. Julia is free to purchase insurance from any company or agency she chooses. If Richard were to coerce Julia to purchase insurance from White by telling Julia that the loan on her new car will be denied unless Julia purchases a policy from White, Richard would be guilty of an unfair trade practice because Richard would be requiring a tie-in sale—tying the sale of insurance to the financing of the car.

Rebating

The prohibition of **rebating** means that producers are not allowed to pay a portion of the premium or give any commission to a policyholder. This ban on rebating also means that producers are not permitted to offer to do other business with the policyholder in exchange for the purchase of a policy. Most states have enacted anti-rebating laws.

Rebating is offering anything of value, other than the insurance itself, to an applicant as an inducement to buy or maintain insurance.

However, rebating is permitted in at least one state, California, under many circumstances. Proposition 103, which was passed by California voters in 1988, repealed the law that prohibited insurance agents from rebating part of their commission to clients. As a result, rebates may now be made to California insureds, unless rebates are specifically prohibited by sections of the state's Insurance Code that were not repealed by Proposition 103. A further restriction on rebating exists in California's civil rights laws, which prohibit insurance agents and brokers from offering rebates or varying the size of rebates if the practice arbitrarily discriminates among individuals.

Opponents of anti-rebating laws in other states continue to argue that such laws inhibit competition in the insurance marketplace. Further challenges to these laws might therefore appear in the future.

Other Deceptive Practices

In addition to the specific practices discussed above, unfair trade practices laws prohibit other practices of insurers that are deceptive or unfair to applicants and insureds. For example, these laws prohibit an insurer and its agents from making a false statement about the financial condition of another insurer. Thus, an agent for IIA Insurance Company, could not legally mislead his client by saying that XYZ Insurance Company has a poor financial rating in the hope of discouraging the client from purchasing insurance from XYZ.

It is also an unfair trade practice to put false information on an insurance application to earn a commission from the insurance sale. Occasionally, some information might lead the insurance company to reject the application, resulting in the producer not earning a commission. Producers are required to be honest in the information they enter on application forms. Both insurance companies and policyholders count on insurance transactions being conducted in utmost good faith.

Educational Objective 10

Define or describe each of the Key Words and Phrases for this assignment. (All Key Words and Phrases appear in bold print in the text and in boxes in the margins throughout this chapter.)

Summary

Insurance marketing is the process of identifying potential customers and then creating and supplying the insurance products and services they need. Although there are many facets to this process, the initial contact between an insurance company and its policyholders is typically through an agent or another type of producer. Thus, a major marketing concern is the insurance company's relationship with its producers.

The legal relationship of agency empowers the insurance producer, the agent, to act on behalf of the insurance company, the principal. Normally, insurance companies make very specific agency contracts with their producers. An agent owes specific duties, such as loyalty and obedience, to the principal in acting for the principal's benefit; and the principal owes certain duties to the agent, such as compensation for services. The principal is legally bound by any acts of the agent that are within the agent's authority. The agent's authority includes the express authority stated in the agency contract, implied authority that is not expressly granted, and the apparent authority a third party might reasonably expect the agent to have.

The specific relationship an insurance company has with its producers reflects the type of marketing or distribution system the company uses to distribute its products. While there are many insurance marketing systems, the traditional types are the independent agency system, the exclusive agency system, the direct writing system, and the direct response system. Independent agents are in business for themselves, they usually represent several different insurance companies, and they own their expiration lists. Exclusive agents represent only one insurance company, adhering to its programs and procedures, even though they are also in business for themselves. The sales representatives of direct writers are the insurers' own employees. The direct response system relies on direct mail, Internet, or telephone contact with customers. Insurers increasingly use more than one distribution system in a mixed marketing system.

The compensation of insurance producers includes commissions and salaries. The sales commissions paid to agents and brokers are a percentage of the insurance premiums they produce. Sales commissions are often supplemented by contingent commissions, which reflect the volume and profitability of that business for the insurer. The sales representatives of direct writers receive a salary, which might be supplemented by a bonus reflecting sales performance.

Advertising, another aspect of insurance marketing, reflects the marketing system used. Insurers relying on independent agents usually advertise to promote the company image, while independent agents try to attract local customers to their offices; joint advertising campaigns are often used to serve the needs of both the agent and the insurer. Exclusive agency companies tend to emphasize both the company name and the local service. Direct writing insurance companies advertise primarily to promote the company's name and products with the public. Direct response insurers rely heavily on advertising to bring customers to them.

An insurer's marketing management activities include producer supervision, producer motivation, and product management and development. Insurers motivate producers through personal contact and through incentive programs developed in the home office. Through product management and development activities, insurers attempt to provide producers with the products needed to produce business for the insurance company.

State regulators oversee the marketing activities of insurance companies and their agents. Insurance producers must meet the specified requirements to obtain and maintain a license in the state or states where they transact business. States prohibit unfair trade practices such as misrepresentation and false advertising, tie-in sales, rebating, and other deceptive practices.