Chapter 24
Types of Private Insurers and Marketing Systems

Overview

There are a number of types of insurance organizations: mutual companies, stock companies, fraternals, reciprocal exchanges, Lloyd’s of London, Blue Cross/Blue Shield plans, and health maintenance organizations (HMOs). There are also a variety of insurance marketing systems. The individual marketing insurance may be an independent agent, an exclusive agent, a direct writer, or a general agent. Coverage also may be purchased through an employer-based group plan or in response to phone or mail solicitation. The prospective purchaser might enlist the services of an insurance broker to purchase insurance. In this chapter, we examine the types of private insurers, distinctions between agents and brokers, and types of marketing systems employed by property and liability insurers and life and health insurers.

Learning Objectives

After studying this chapter, you should be able to:

• Describe the major types of private insurers, including the following: stock insurers, mutual insurers, reciprocal exchanges, Lloyd’s of London, Blue Cross and Blue Shield plans, and health maintenance organizations (HMOs).

• Explain why some life insurers have demutualized or formed holding companies in recent years.

• Explain the difference between an agency building system and a nonbuilding agency system as life insurance marketing systems.

• Describe the direct response system for selling life insurance.

• Describe the marketing systems in property and casualty insurance, including: independent agency system, exclusive agency system, direct response system, direct writers, and mixed systems.

• Define the following:
  
  - Advance premium mutual
  - Agency building system
  - Agent
  - Assessment mutual
  - Broker
  - Captive insurer
  - Contingent or profit-sharing commission
  - Demutualization
  - Direct response system
  - Direct writer
  - Exclusive agency system
  - Expirations or renewal rights to business
  - Fraternal insurer
  - General agency system
  - Holding company
  - Independent agency system
  - Lloyd’s of London
  - Managerial system
  - Mass merchandising
  - Multiple distribution systems
  - Mutual insurer
  - Nonadmitted insurer
  - Nonbuilding agency system
  - Personal-producing general agent
  - Reciprocal exchange
  - Savings bank life insurance (SBLI)
  - Stock insurer
  - Surplus lines broker

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Outline

I. Overview of Private Insurance in the Financial Services Industry

II. Types of Private Insurers
   A. Stock Insurers
   B. Mutual Insurers
   C. Lloyd’s of London
   D. Reciprocal Exchanges
   E. Blue Cross and Blue Shield Plans
   F. Health Maintenance Organizations
   G. Other Private Insurers

III. Agents and Brokers
   A. Agents
   B. Brokers

IV. Types of Marketing Systems
   A. Life Insurance Marketing Systems
      1. Agency Building System
      2. Nonbuilding Agency System
      3. Direct Response System
   B. Property and Liability Insurance Marketing Systems
      1. Independent Agency System
      2. Exclusive Agency System
      3. Direct Writer
      4. Direct Response System
      5. Multiple Distribution System

V. Group Insurance Marketing

Short Answer Questions

1. List the different types of mutual insurers.
2. The financial services sector in recent years has been characterized by consolidation and convergence. What is the meaning of these terms with respect to the financial services sector?

3. How do stock insurance companies and mutual insurance companies differ?

4. How does an advance premium mutual differ from an assessment mutual?
5. What are the distinctive characteristics of Lloyd’s of London?

6. What are the differences between insurance agents and brokers?

7. If a business needs a specific type of insurance, and none of the insurers licensed to operate in its state market that type of insurance, how can the business obtain the coverage?
8. What are the primary methods of marketing life insurance coverage?

9. What are the primary methods of marketing property and liability insurance coverage?

10. What are the characteristics of mass merchandising?
Multiple Choice Questions

Circle the letter that corresponds to the BEST answer.

1. Cindy sells property and liability insurance. She is a salaried employee of the one company that she represents. Cindy is a(n):
   (a) independent agent  
   (b) general agent  
   (c) exclusive agent  
   (d) direct writer

2. Which statement(s) about mutual insurers is(are) true?
   I. They are owned by their policyowners.
   II. Some mutual insurers are permitted to assess policyowners if losses are higher than anticipated.
   (a) I only  
   (b) II only  
   (c) both I and II  
   (d) neither I nor II

3. All of the following methods are used to distribute life insurance EXCEPT:
   (a) independent agency system  
   (b) general agency system  
   (c) managerial system  
   (d) direct response system

4. Some mutual companies have gone through a conversion process and have become stock insurance companies. All of the following are advantages of the stock form of organization relative to the mutual form of organization EXCEPT:
   (a) the ability to offer stock options may make it easier to attract and retain key personnel  
   (b) it’s easier to raise capital as a stock organization  
   (c) stock insurance companies are exempt from state premium taxes and federal income taxes  
   (d) stock insurers have greater flexibility to expand by acquiring other companies

5. A plan for providing property and liability insurance to individuals in a group under a single program of insurance at reduced rates is called:
   (a) surplus lines insurance  
   (b) direct response  
   (c) direct writing  
   (d) mass merchandising

6. John would like to start a business raising race horses. When he inquired about insurance coverage for race horses, he learned that none of the insurers operating in his state sell that particular type of coverage. In his state, insurance on race horses would be described as a(n):
   (a) monoline  
   (b) expired line  
   (c) surplus line  
   (d) multiple line

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7. All of the following channels are used to distribute property and liability insurance EXCEPT:
   (a) general agency system
   (b) independent agency system
   (c) direct writers
   (d) exclusive agency system

8. What type of insurer can be defined as an unincorporated mutual in which each member insures the other members and, in turn, is insured by the other members?
   (a) stock insurer
   (b) assessment mutual
   (c) reciprocal exchange
   (d) fraternal insurer

9. Which statement is true with regard to agents and brokers?
   I. Life insurance agents typically have greater authority to bind coverage than do property and liability insurance agents.
   II. Brokers legally represent insurance purchasers, not insurers.
   (a) I only
   (b) II only
   (c) both I and II
   (d) neither I nor II

10. Which statement is true with regard to independent insurance agents?
    I. They are compensated through a salary paid by the insurers they represent.
    II. They represent only one insurer.
    (a) I only
    (b) II only
    (c) both I and II
    (d) neither I nor II

11. Bruce obtained health insurance coverage from a nonprofit prepayment plan that provides coverage for physicians’ and surgeons’ fees and hospital services. Bruce obtained this coverage from a:
    (a) Blue Cross and Blue Shield plan
    (b) mutual insurer
    (c) stock insurer
    (d) health maintenance organization (HMO)

12. Because demutualization is a slow and cumbersome process, some states have enacted legislation that allows a mutual company to be reorganized so that it may own or acquire control of stock companies that can issue additional shares of common stock. The reorganized mutual company is called a(n):
    (a) mutual holding company
    (b) captive insurance company
    (c) shell insurance company
    (d) fronting insurance company
True/False

Circle the T if the statement is true, the F if the statement is false. Explain to yourself why a statement is false.

T   F  1. Mutual insurers guarantee dividend payments to their policyowners.

T   F  2. A captive insurance company is a mutual insurance company that is owned by a stock insurance company.

T   F  3. The managerial system is a distribution system for property and liability insurance.

T   F  4. Exclusive agents represent only one insurer or a group of insurers under common ownership.

T   F  5. Mass merchandising refers to selling life and health insurance through the mail, newspapers, or other media.

T   F  6. Surplus lines brokers are authorized to place coverage with nonadmitted insurers.

T   F  7. Lloyd’s of London restricts its underwriting to heterogeneous loss exposures, such as a star quarterback’s arm or a famous dancer’s legs.

T   F  8. Mutual insurance companies may only write life and health insurance.

T   F  9. Stock insurance companies frequently issue assessable insurance polices.

T   F  10. Fraternal insurance companies are one type of mutual insurer.

T   F  11. An independent agent, rather than the company he or she represents, owns expiration rights to the coverage the independent agent has sold.

T   F  12. Blue Cross/Blue Shield organizations stress service benefits rather than cash benefits.

T   F  13. Demutualization makes it more difficult for an insurer to raise capital.

T   F  14. Personal-producing general agents are hired to sell insurance and not to recruit new agents.

Case Applications

Case 1

For many years, Sarah Jane was a successful independent insurance agent. Recently, she was recruited by two insurance companies. With the first company, Sarah Jane would be an exclusive agent. With the second company, she would be a direct writer. What changes would Sarah Jane observe if she switched from being an independent agent to operating as an exclusive agent or direct writer?
Case 2

Benson Insurance gives an award each year to the agent who sells the most insurance coverage. In three of the last five years, this award was won by Clark Edwards. In an effort to determine what makes Clark such a successful agent, Benson Insurance Company decided to examine the business he produced. In the examination, the company learned that insureds solicited by Clark had 50 percent more claims than business solicited by other Benson Insurance agents. Benson Insurance is rethinking how the company compensates and rewards its agents. How might compensation and rewards be restructured to obtain better underwriting results?

Solutions to Chapter 24

Short Answer Questions

1. The types of mutual insurers include: assessment mutuals, advance premium mutuals, and fraternal insurers.

2. Consolidation means that the number of firms operating in the financial services market has declined over time because of mergers and acquisitions. Announcements of bank mergers and insurance company mergers have become commonplace. The obvious result is fewer, but on average larger, financial services organizations.

Convergence means that financial institutions can now sell a wide variety of products outside their core business area. Prior to the passage of the Gramm-Leach-Bliley (The Financial Modernization Act of 1999), a financial services company had limited ability to operate outside of its core area—banks concentrated on banking, insurers sold insurance, and securities firms handled investments. Today, we see convergence—for example, one large personal lines insurance company now offers mutual funds, depository operations (banking), and extends mortgage loans.

3. Stock insurance companies are owned by their stockholders who participate in the profits and losses of the insurer. Stock companies cannot issue assessable policies. Mutual companies are owned by their customers, the policyowners. If the experience of the mutual insurer is favorable, the company may refund a portion of the premiums paid to the policyowners through dividend payments.

4. Advance premium mutuals charge a premium up-front that is expected to be sufficient to pay all claims and expenses. If premiums are not sufficient, any deficit is made up through the surplus of the organization, which is the difference between the insurer’s assets and liabilities. Assessment mutuals reserve the right to levy an additional charge against policyowners if the premiums originally charged are not sufficient to cover claims and expenses.
5. Lloyd’s of London has several distinctive characteristics. First, Lloyd’s of London is technically not
an insurance company but rather an association providing services to its members. Second, the
insurance coverage is written through syndicates that belong to Lloyd’s of London. Third, new
“names” have limited liability with respect to the insurance they write as individuals. Fourth,
corporations with limited liability can also join Lloyd’s of London. Fifth, individual members must
meet stringent financial requirements. Finally, Lloyd’s of London is licensed only in a small number
of jurisdictions in the United States.

6. An insurance agent is someone who legally represents an insurer and has the authority to act on the
insurer’s behalf. Brokers legally represent insurance buyers who are seeking coverage. Brokers don’t
have authority to bind an insurer. Both agents and brokers are compensated through commissions.

7. In this situation, the business would obtain coverage through a nonadmitted insurer. As such an
insurer has not been admitted to operate in the state, the insurer will not have sales representatives in
the state. To obtain coverage with a nonadmitted insurer, a specialist known as a surplus lines broker
may be used. Surplus lines brokers are authorized to place coverage with nonadmitted insurers.

8. The primary methods of marketing life insurance coverage include: the agency building system
(which includes the general agency system and managerial system), the nonbuilding agency system,
and the direct response system.

9. The primary methods of marketing property and liability insurance coverage include: the independent
agency system, the exclusive agency system, through direct writers, the direct response system, and
through multiple distribution systems.

10. Mass merchandising has a number of distinctive characteristics. First, property and liability insurance
is sold to individual members of a group. Second, individual underwriting is employed. Third, rates
are lower because of lower commissions and lower administrative expenses. Finally, employees
usually fund all of the coverage without contributions from employers.

Multiple Choice Questions

1. (d) Cindy is a direct writer. Direct writers and exclusive agents are both affiliated with only one
company. Direct writers are salaried employees while exclusive agents are compensated through
commissions.

2. (c) Both statements are true. Mutual insurers are owned by their policyowners and have no
stockholders. Assessment mutuals can assess policyowners if losses are higher than anticipated.

3. (a) The independent agency system is used to market property and liability insurance. The other
methods listed are used to market life insurance.

4. (c) Stock companies are not exempt from state premium taxes and federal income taxes. The other
statements are true with respect to stock companies compared to mutual companies.

5. (d) Mass merchandising has all of the characteristics described.

6. (c) Surplus lines are those coverages for which there is no market in the state. John would have to
obtain coverage from a nonadmitted insurer using the services of a surplus lines broker.
7. (a) General agency is a marketing system used to distribute life insurance coverage.

8. (c) A reciprocal exchange has the characteristics described.

9. (b) Property and liability insurance agents typically have greater authority to bind the insurer than do life insurance agents. Brokers represent insurance buyers, not insurers.

10. (d) Neither statement is true. Independent agents are not employees of insurance companies and are not paid salaries. Independent agents are independent business men and women who represent more than one insurer. They are compensated through commissions.

11. (a) Blue Cross and Blue Shield plans are typically non-profit prepayment plans that provide coverage for hospital services and physicians’ and surgeons’ fees.

12. (a) The mutual insurance company is reorganized as a holding company that can own or acquire stock companies.

**True/False**

1. F Although mutual companies may pay dividends to policyowners, the dividend payments are not guaranteed.

2. F A captive insurance company is an insurance company that is owned by a parent company for the purpose of insuring the parent company’s loss exposures. A petroleum company, for example, may establish a captive insurance company to provide pollution liability coverage for the parent firm.

3. F The managerial (branch office) system is a life insurance distribution system, not a property and liability insurance distribution system.

4. T

5. F What is described is direct response, not mass merchandising. Mass merchandising refers to selling property and liability insurance to individual members of groups.

6. T

7. F Although Lloyd’s of London receives notoriety for writing heterogeneous risks like these, Lloyd’s of London is also an important player in ocean marine insurance, reinsurance, and other areas.

8. F There are many mutual insurance companies that write property and liability insurance. Liberty Mutual Insurance Company and State Farm Insurance Company are two excellent examples of mutual insurance companies that market property and liability coverage.

9. F Only certain types of mutual insurers can issue assessable policies. Stock companies cannot issue assessable policies.

10. T

11. T
12.  

13.  
Demutualization makes it easier to raise new capital. Under the mutual ownership structure, there are no publicly-traded ownership rights. If a stock company (e.g., a demutualized insurer) wishes to raise more capital, it can sell shares of stock to raise more money.

14.  

Case Applications

Case 1

As an independent agent, Sarah Jane is an independent businessperson representing more than one insurer. She owns the expiration rights to the coverage she sells and her renewal commissions are equal to the commissions earned on new business. As an exclusive agent, Sarah Jane would still be an independent businessperson, however she would represent only one company. The company, rather than Sarah Jane, would own the expiration rights and a higher commission would be paid on new business than on renewal business. If she takes the job as a direct writer, Sarah Jane will be an employee rather than an agent. She will be paid a salary and will represent only one insurer.

Case 2

If Clark is being compensated on a straight commission basis, he has an incentive to sell as much insurance coverage as possible. To do this, he may be soliciting bad risks, and some of these bad risks may be slipping past the company’s underwriters and producing an above-average number of claims. Rather than only considering the quantity of coverage sold, Benson Insurance could also consider the quality of the applicants solicited by its agents. Benson Insurance could, for example, consider the ratio of losses paid to premium dollars written by Benson Insurance agents, and award commissions that consider the loss ratio of business generated by the agent (profit-sharing commissions). The annual award could be changed from an award based on quantity only to an award recognizing quantity and quality of coverage sold.