

# Critical Success Factors in Managing the Risk in Program Business

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# Overview

- **Key terms:** No standard definitions
- **Why** is program business attractive to insurers and reinsurers?
- **What** are the main underwriting risks in a softening market?
- **How** can these risks be best addressed?
- **Conclusions:** “Déjà vu all over again” in the near term future?

Note: The opinions expressed in this presentation are the personal opinions of the presenter and do not express or imply the opinions of Navigant Consulting, Inc.

## Key Terms – No standard definitions...

### “Program Business” – TMPAA Definition

*“Insurance products targeted to a particular niche market or class, generally representing a book of **similar risks** placed with one carrier. Administration is done through Program Specialists who have developed an expertise in that market or class. Administration responsibilities are negotiated between the Specialist and Carrier, and may include **marketing, underwriting selection, binding, issuing, billing, premium collections, data gathering, claims management/loss control, and possibly risk sharing.** Program Specialists typically target their niches through differentiation either in product, risk management services, delivery mechanism or price. Specialists can distribute these Programs on a **retail or wholesale** basis.” (Emphasis Added)*

Source: Target Markets Program Administrators Association (TMPAA), *Program Business Definition*, Accessed 7/17/07 at [http://www.targetmkts.com/pdf/best\\_practice\\_protocol.pdf](http://www.targetmkts.com/pdf/best_practice_protocol.pdf)

Key terms: No standard definition

*The definition of MGA varies but NAIC model law is most common...*

Managing General Agent (MGA) *Effective 7/1/06 (SB 289)*

...“managing general agent” means a person who

(A) **manages all or part of the insurance business of an insurer**, including the managing of a separate division, department, or underwriting office; and

(B) acts as an agent for an insurer, whether known as a managing general agent, manager, **or other similar term**, who, **with or without the authority**, separately or together with affiliates, **produces, directly or indirectly, and underwrites** an amount of gross direct written premium equal to or more than five percent of the policyholder surplus as reported in the last annual statement of the insurer in any one quarter or year together with the following activity related to the business produced, adjusts or pays claims over \$10,000 a claim, or negotiates reinsurance on behalf of the insurer. [Emphasis Added.]

Source: Alaska D.O.I, Bulletin B 06-11, to All Licensees and admitted insurers in the state of Alaska, Accessed 7/20/07 at <http://www.dced.state.ak.us/insurance/bulletins/B06-11.pdf>

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# Why program business is attractive...

*Many long-term success stories...*



**American Psychological Association Insurance Trust**



# Why program business is attractive...

Underwriting perspective: 3 important considerations



1. Meaningful Premium Growth,
2. Specialty Product Line Expertise,
3. *Sustainable* Distribution Advantage.

*Best Possible Opportunities: Combine all three of the above*

# Why program business is attractive...

## MGA Perspective – 5 Reasons



1. Meaningful Premium Growth,
2. Specialty Product Line Expertise,
3. *Sustainable* Distribution Advantage,
4. Improved Customer Service,
5. New produce development

# Why program business is attractive...

## Positive growth & profitability 1981 - 2001



- “Non-admitted” direct written premium grew by over 600% between 1981 and 2001 compared to less than 300% growth in the admitted market.
- Commercial surplus lines market share grew from 3.9% in 1981 to 8.4% in 2001.
- Industry experts estimate that in 2002 excess & surplus lines insurers produced a 95% combined ratio compared to 107.2% for the total P&C market, and 121% for professional reinsurers.

Source: Ronnie Moore, *Quantifying the Qualitative Value of Managing General Agents*, August 2003:

[http://www.aamga.org/files/RONNIE\\_MOORE\\_EXPERT\\_COMMENTARY.htm](http://www.aamga.org/files/RONNIE_MOORE_EXPERT_COMMENTARY.htm)

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# What are the main underwriting risks?

- **Control Risk**
- **Strategic & Financial**
- **Legal & Regulatory**

# Control Risk: “Who are those guys?”

This critical first step to any new relationship requires a rigorous and objective approach...



- Trust and “utmost good faith” remain the imperative assumptions to all MGA, insurer, and reinsurer agreements.
- Extensive background & reference checks are critical to the decision to enter an MGA relationship.
- Who is financially backing the MGA?
- Data integrity in a program proposal also needs to be questioned: Is it complete or selective? What is the source?
- Is the proposed staff (really) qualified to perform the proposed tasks? Will the MGA “lead” or “follow”?
- Is the MGA’s value purported competitive advantage sustainable in a softening market?

# Control Risk

Direct writing insurers have the lowest “control risk” with captive agents or licensed employees managing the entire transaction with the insurance buyer ( personal lines and many forms of professional liability, such as allied health care)



Insurance Buyer



Directive Writing Insurer  
(Captive Agents or  
Licensed Employees)

# Control Risk

Commercial business is mostly produced by independent agents or brokers with, at minimum, three parties in the chain of commerce, representations, and communications.



Insurance Buyer



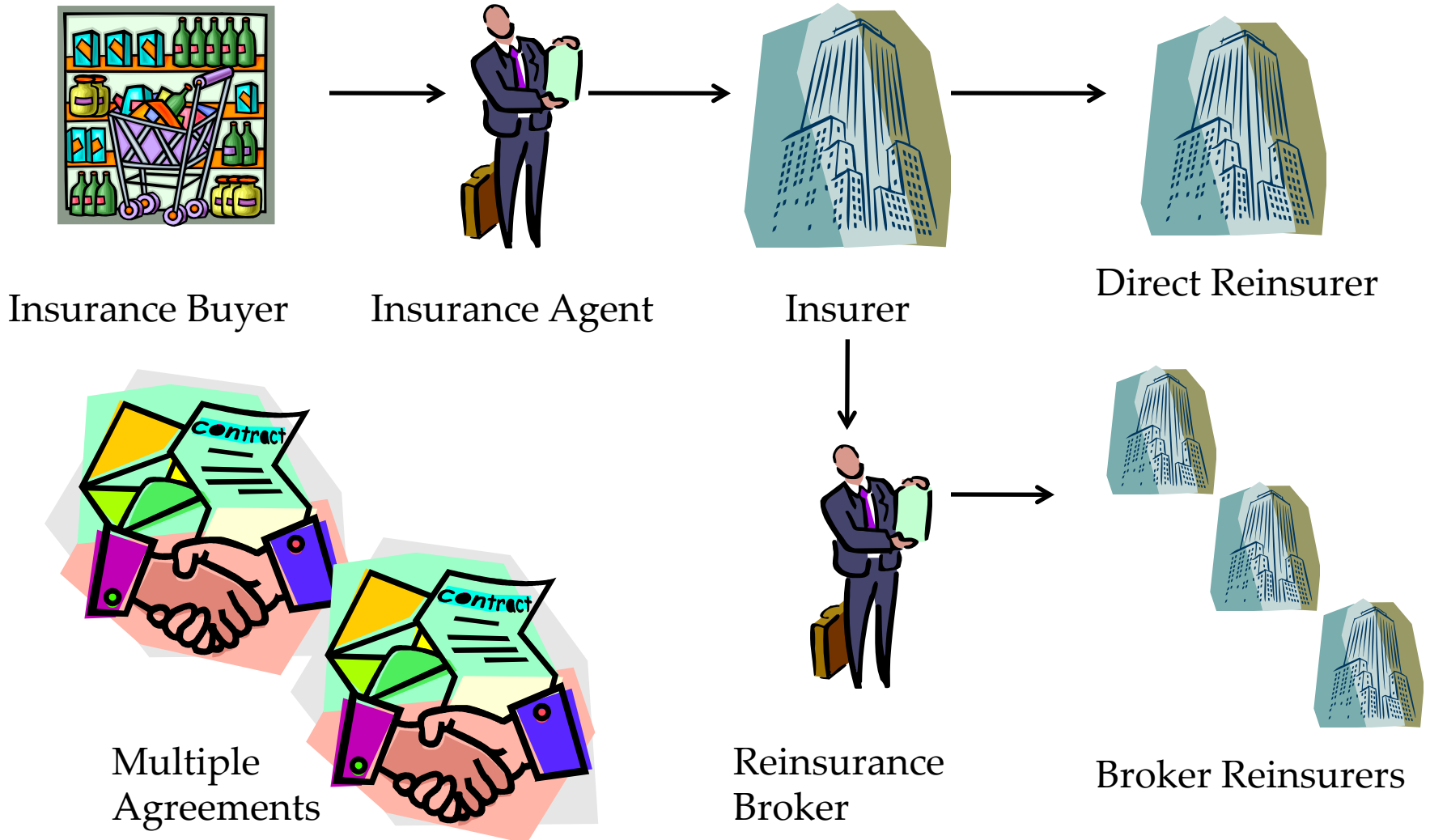
Insurance Agent or Broker



Insurance Company

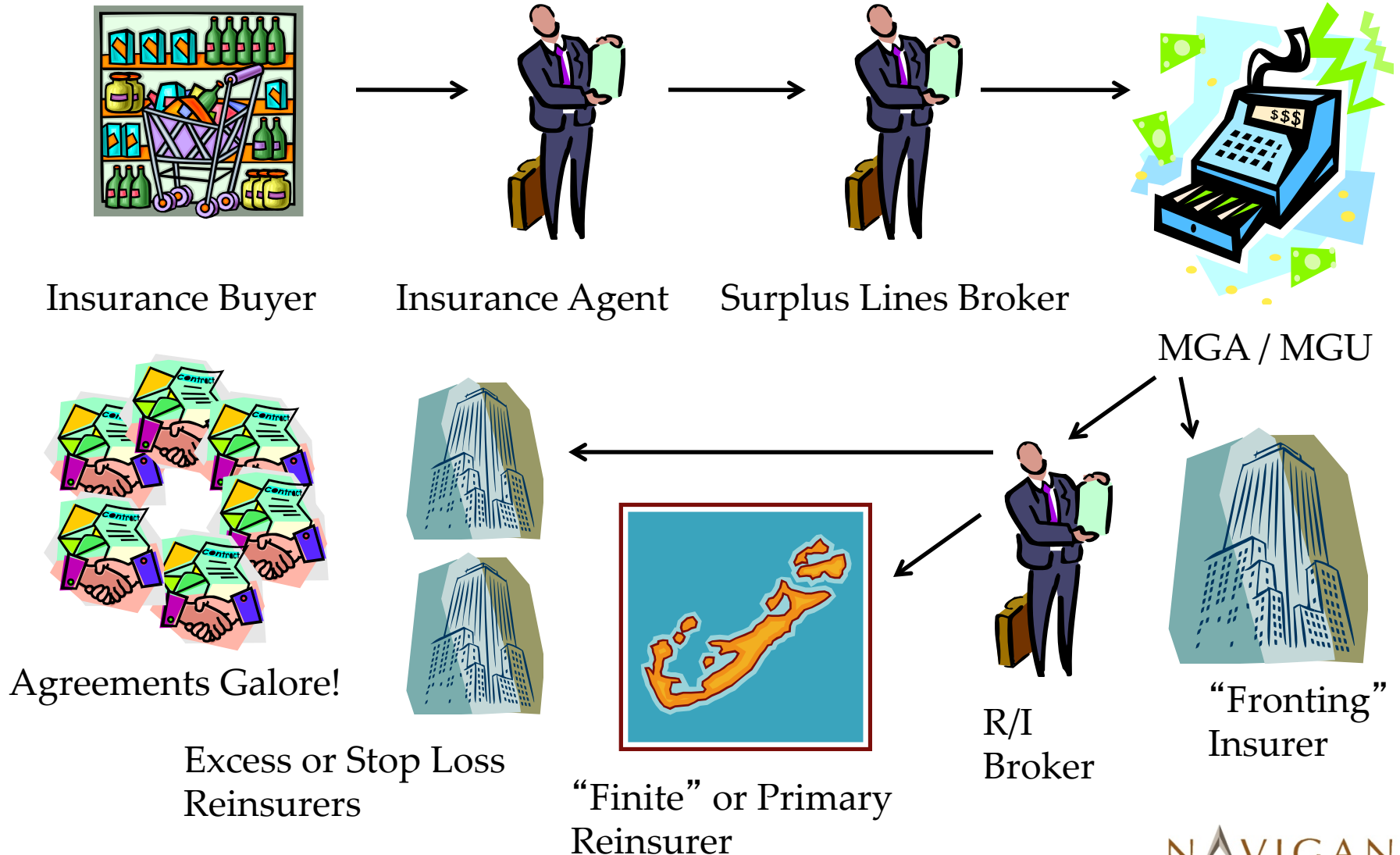
# Control Risk

More typically *a minimum of four parties* are involved in the chain of commercial insurance dollars (not including retrocessionaires or catastrophe / clash reinsurers)



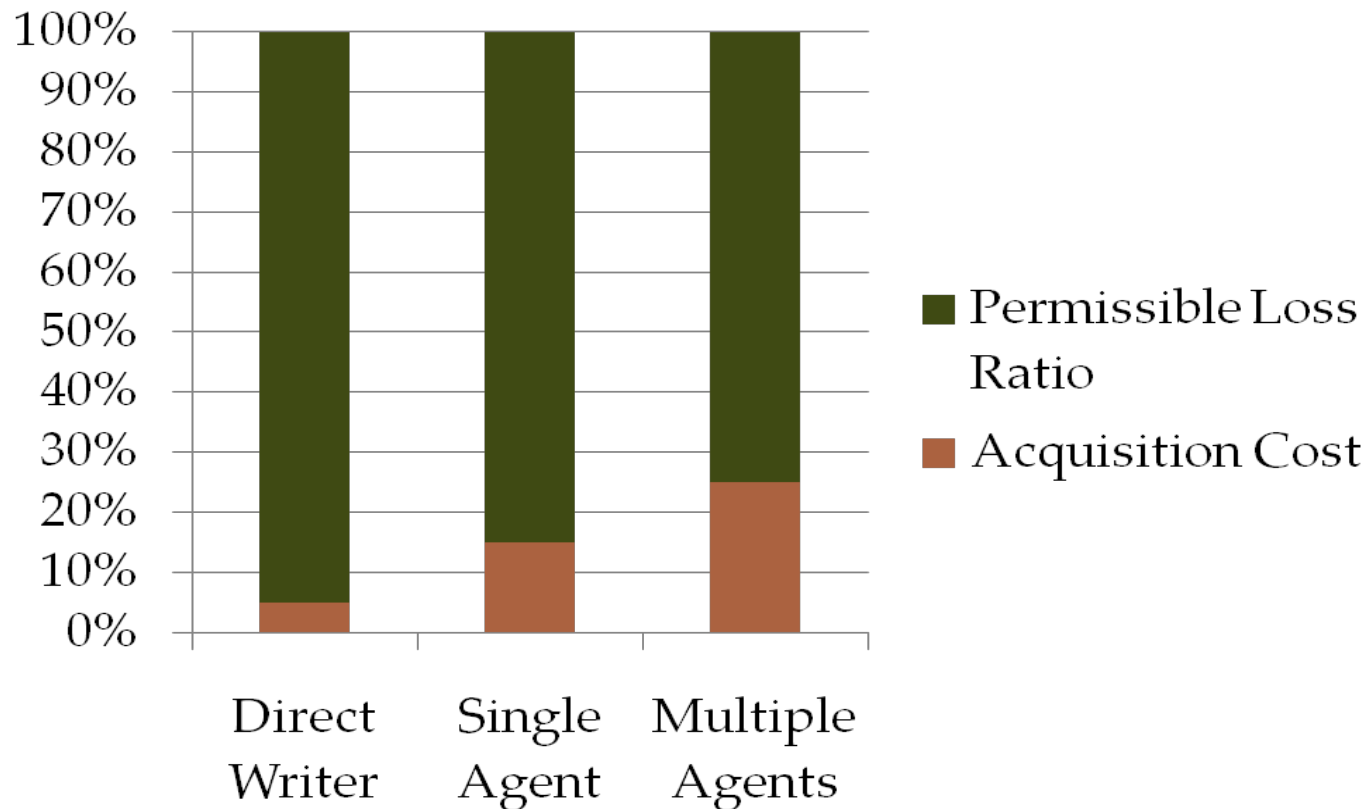
# Control Risk

The “Alternative Market” of the late nineties introduced new complexities as many reinsurers dealt directly with MGAs



# Strategic & Financial

Program business through MGAs typically requires additional acquisition costs of at least 20% over the costs of a Direct Writer and 10% more than brokered business, making a 100% combined ratio more difficult to achieve...



# Two Options in a Softening Market

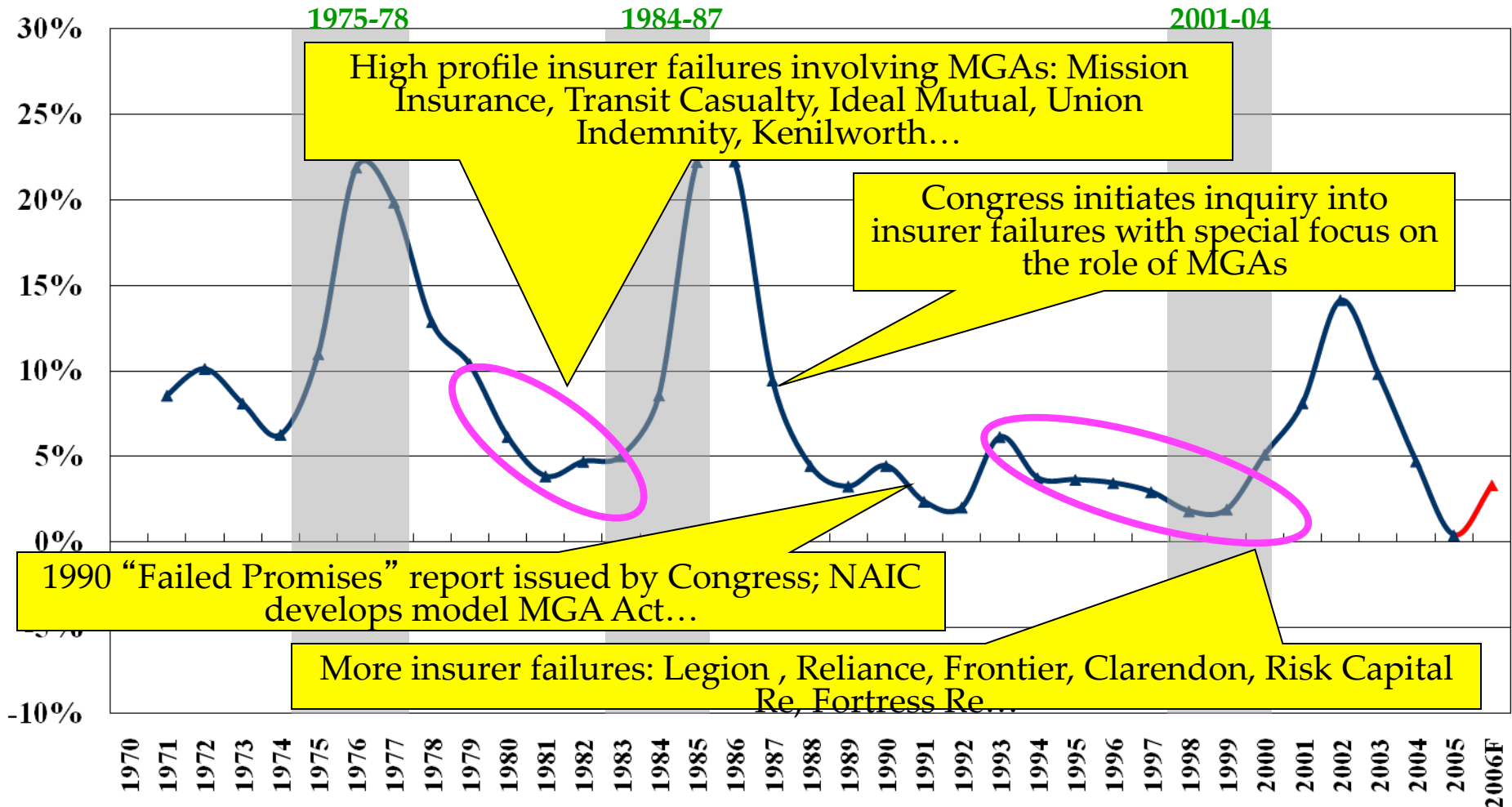
Assuming an exit strategy is not being considered, there are two basic options for surviving a competitive market like the one we are seeing now...

- **“Stick to the knitting” (Reduce Premiums / Maintain strict controls)**
- **“Go for it!” (Grow Premiums but Purchase - a lot! - more reinsurance)**

# Strategic & Financial

## Is timing “everything”?

Domestic P&C Market Cycle -Growth in Net Written Premium: 1970 -2006



Note: Shaded areas denote hard market periods.

Source: A.M. Best, Insurance Information Institute

# Option 1: United National Insurance Group

Let the top line DWP decline from 1994 through 1998 and increased net retention slightly...

| United National Ins. Group<br>(A.M. Best "A+" Rated as of year end 1998) |              |               |               |                           |               |               |                |                       |
|--|--------------|---------------|---------------|---------------------------|---------------|---------------|----------------|-----------------------|
| Year   | DWP<br>(\$M) | NWP<br>(\$ M) | Net<br>Ret. % | Op. Cash<br>Flow<br>(\$M) | Loss<br>Ratio | Exp.<br>Ratio | Comb.<br>Ratio | P&C<br>Comb.<br>Ratio |
| 94   | \$289.5      | \$102.8       | 30.4%         | \$23.3                    | 72.6%         | 19.5%         | 92.1%          | 112.1%                |
| 95   | 195.1        | 86.8          | 35.8          | 29.7                      | 75.7          | 17.6          | 93.3           | 109.4                 |
| 96   | 221.3        | 97.2          | 36.0          | 21.6                      | 73.7          | 22.7          | 96.3           | 106.7                 |
| 97   | 219.3        | 95.5          | 36.1          | 17.4                      | 66.4          | 19.1          | 85.5           | 103.4                 |
| 98   | 224.9        | 101.1         | 34.1          | 26.9                      | 66.0          | 18.8          | 84.8           | 108.6                 |

Note: DWP is "direct written premium". "NWP is "net written premium". NWP equals DWP plus assumed reinsurance minus amounts ceded to unaffiliated reinsurers. "Net. Ret. %) is the percentage of NWP to DWP. "Reins. Rec. % PHS" is the year end percentage of the reinsurance amount receivable to the insurers policyholder surplus (PHS). The "comb. ratio" is the "combined ratio", equaling sum of the Loss and Expense Ratios. "Op. Cash Flow" is the year end Operating Cash Flow. (*Best's Key Rating Guide*, 1999 Edition, p. 688-689) The "P&C Comb. Ratio" is the overall combined ratio for commercial lines insurers (*Best's Aggregates & Averages*, 1999 Edition, page 268).

## Option 2: Clarendon Insurance Group (1994-1998):

More than tripled DWP, increased reinsurance purchases, lowered expense ratio and the combined ratio but resulted in negative cash flow...

| Clarendon Ins. Group (A.M. Best "A" Rated as of year end 1998) |           |            |            |                     |            |            |             |                 |
|--|-----------|------------|------------|---------------------|------------|------------|-------------|-----------------|
| Year   | DWP (\$M) | NWP (\$ M) | Net Ret. % | Op. Cash Flow (\$M) | Loss Ratio | Exp. Ratio | Comb. Ratio | P&C Comb. Ratio |
| 94   | \$336.5   | \$163.7    | 41.7%      | \$16.2              | 67.9%      | 27.6%      | 95.5%       | 112.1%          |
| 95   | 538.9     | 258.9      | 40.2%      | 47.6                | 67.1       | 24.4       | 91.4        | 109.4           |
| 96   | 757.6     | 272.5      | 31.0%      | 25.8                | 75.5       | 15.6       | 91          | 106.7           |
| 97   | 959.9     | 234.4      | 22.3%      | 31.7                | 71.4       | 14.6       | 86.1        | 103.4           |
| 98   | 1,171     | 198.4      | 15.8%      | (\$45.8)            | 87.5       | 9.7        | 97.2        | 108.6           |

Note: DWP is "direct written premium". "NWP is "net written premium". NWP equals DWP plus assumed reinsurance minus amounts ceded to unaffiliated reinsurers. "Net. Ret. %) is the percentage of NWP to DWP. "Reins. Rec. % PHS" is the year end percentage of the reinsurance amount receivable to the insurers policyholder surplus (PHS). The "comb. ratio" is the "combined ratio", equaling sum of the Loss and Expense Ratios. "Op. Cash Flow" is the year end Operating Cash Flow. (Best's Key Rating Guide, 1999 Edition, p. 144-145) The "P&C Comb. Ratio" is the overall combined ratio for commercial lines insurers (Best's Aggregates & Averages, 1999 Edition, page 268).

# Option 2: Legion Insurance Group

Similar to Clarendon, grew dramatically and relied too heavily on increased reinsurance purchases...

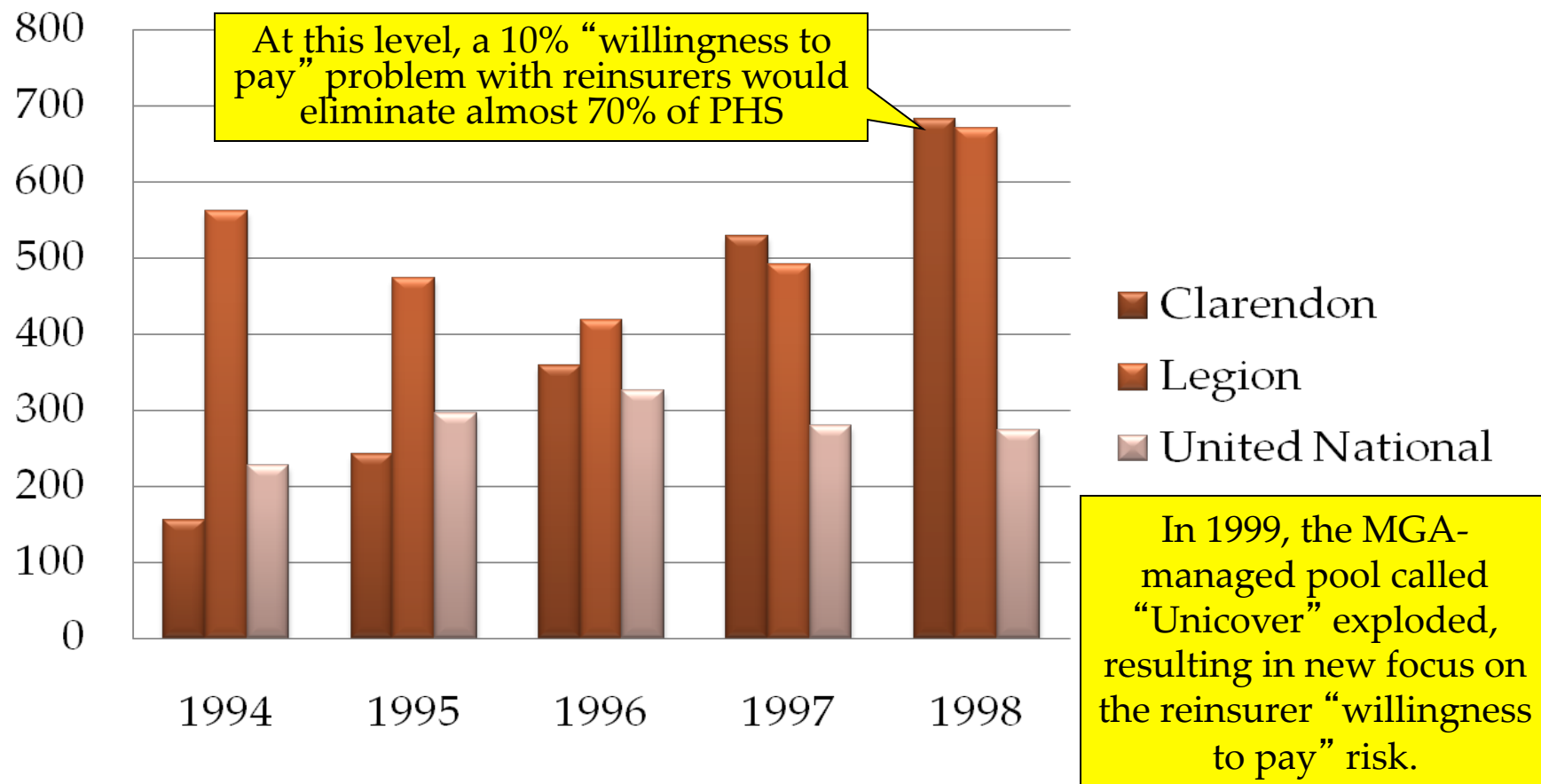
| Legion Ins. Group (A.M. Best "A" Rated as of year end 1998) |           |            |            |                     |            |            |             |                 |
|---|-----------|------------|------------|---------------------|------------|------------|-------------|-----------------|
| Year  | DWP (\$M) | NWP (\$ M) | Net Ret. % | Op. Cash Flow (\$M) | Loss Ratio | Exp. Ratio | Comb. Ratio | P&C Comb. Ratio |
| 94  | \$242.8   | \$98.8     | 35.8%      | \$43.1              | 68.5%      | 19.4%      | 87.8%       | 112.1%          |
| 95  | 242.9     | 53.4       | 20.1       | 19.7                | 76.8       | 9.5        | 86.3        | 109.4           |
| 96  | 339.1     | 49.6       | 14.7       | 10.8                | 93.3       | -4.3       | 88.9        | 106.7           |
| 97  | 573.5     | 83.6       | 14.5       | 2.1                 | 90.5       | -4.5       | 86.3        | 103.4           |
| 98  | 744.9     | 103.7      | 13.2       | (81.9)              | 92.2       | 6.1        | 98.9        | 108.6           |

Note: DWP is "direct written premium". "NWP is "net written premium". NWP equals DWP plus assumed reinsurance minus amounts ceded to unaffiliated reinsurers. "Net. Ret. %) is the percentage of NWP to DWP. "Reins. Rec. % PHS" is the year end percentage of the reinsurance amount receivable to the insurers policyholder surplus (PHS). The "comb. ratio" is the "combined ratio", equaling sum of the Loss and Expense Ratios. "Op. Cash Flow" is the year end Operating Cash Flow. (Best's Key Rating Guide, 1999 Edition, p. 380-381) The "P&C Comb. Ratio" is the overall combined ratio for commercial lines insurers (Best's Aggregates & Averages, 1999 Edition, page 268).

# Rocketing Reinsurance Recoverable Risk:

Clarendon and Legion allowed their total reinsurance receivable exposure to exceed 600% of PHS as of year end 1998. United National reduced this exposure as the market continued to soften.

## Reinsurance Recoverable as a % of PHS



Source: A.M. Best, Key Rating Guide 1999

# Legal & Regulatory: “Failed Promises”

The 1990 Congressional report (aka the “Dingell Report”) cited six weaknesses regarding solvency regulation...

- **Delegated management authority:** “excessive reliance on the judgment of managing general agents, brokers, and other companies...”
- **Holding companies and affiliates:** “..can be too easily overleveraged and milked of their liquid assets...”
- **Reinsurance:** “...No one seems to know for sure where the insurance chain goes or whether its links are sound...”

Source: American Academy of Actuaries, *Risk-Focused Surveillance Framework*, June 2006, at: [https://www.actuary.org/pdf/casualty/risk\\_june06.pdf](https://www.actuary.org/pdf/casualty/risk_june06.pdf)

# “Failed Promises – Insurance Company Insolvencies”

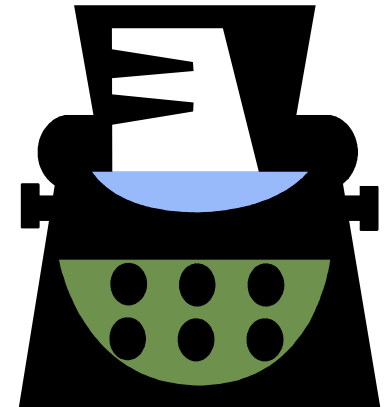
The 1990 Congressional report cited six weaknesses regarding solvency regulation...

- **Unreliable Information:** The data used by regulators was described as “ simply unreliable...”
- **Insufficient regulation:** Solvency regulation, according to the report “suffers from inadequate resources, lack of coordination, infrequent regulatory examination ...and uneven implementation.”
- **Enforcement:** The report stated that the regulatory system “devotes insufficient efforts to investigating the causes of insurance company insolvencies, and punishing the persons who are responsible...”

Source: American Academy of Actuaries, Risk-Focused Surveillance Framework, June 2006, at: [https://www.actuary.org/pdf/casualty/risk\\_june06.pdf](https://www.actuary.org/pdf/casualty/risk_june06.pdf)

# Regulatory Issues: “The Sum of All Fears”

A troubling combination: Christmas Trees, White-Out, and Dec-Pages



# Consider the 1982 case of the Kenilworth Insurance Co. *Is truth stranger than fiction?*



*“On Tuesday of that week, we obtained entrance to the apartment on the 61st Floor of the Lake Point Tower Building in Chicago to find Mr. Patterson, Joyce Splendoria and another young lady apparently carrying on the business of Robco...*

*It was a luxurious, two bedroom apartment completely furnished and decorated with \$60,000 of Kenilworth’s money. What was unusual, however, was that strewn on the floors, shelves and furniture were hundreds of Kenilworth policy files.*

*Ms. Splendoria was sitting at the dining room table with her own set of books, while the young lady was sitting at a typewriter preparing invoices to Kenilworth producers. Mr. Patterson was looking bewildered and somewhat disturbed. He indicated that this was the office of Robco, as were all of the books, records, and policies we found...*

*He was rather rushed that day, however, since he had a meeting with the FBI that afternoon to discuss certain matters unrelated to Kenilworth.”*

Source: Selected quotations from *Kenilworth Insurance Company: A Case Study*, December 1982, William Allen CPA. See: <http://www.jaminhouse.com/kenilworth/>

# Or more recently, the case of Fortress Re

...convicted in 2004 of defrauding Sompo Japan of \$1.12 billion

**Fortress Re Inc.** were an American aviation reinsurance agency, based in Burlington, North Carolina, and co-owned by Maurice 'Chico' Sabbah. Their auditor was Deloitte & Touche.

## Financial trouble

*They were dealt a heavy blow by the September 11 attacks. Fortress Re pooled the funds of several insurance companies to share the risks of reinsuring aviation portfolios. All four planes that crashed on September 11, 2001 were ultimately reinsured into the Fortress Re pool. The participating companies faced claims of \$2.5 billion, and the Fortress Re funds fell far short...Fortress Re stopped writing new business at this time, and has not recommenced.*

## Legal action

Legal actions began from a number of Japanese insurance companies at the start of 2002 towards the directors of Fortress Re, alleging Fortress Re had misrepresented losses and performed other improper acts, including Sabbah and his partner "amassing personal fortunes" by skimming money off the top from Sompo's funds. Sabbah denied any wrongdoing. In 2004, the two directors of Fortress Re were collectively forced to pay \$1.12bn by a court in New York, for defrauding Sompo Japan Insurance.

Source: Accessed 7/17/07 from Wikipedia at: [http://en.wikipedia.org/wiki/Fortress\\_Re](http://en.wikipedia.org/wiki/Fortress_Re)

# Legal & Regulatory Improvements

Many regulatory improvements have been made since the 1990 “Failed Promises Report”

- Federal: OFAC – formally addresses the “Who?” question.
- NAIC & State Regulatory Improvements:
  - More Uniform Producer licensing - Resident & Non-Resident
  - SERF: Electronic filings gaining acceptance, lowering costs.
  - Improved E&S “surplus lines” Licensing
  - Mandatory offerings (Loss Control, TRIA, etc.)
  - Market Conduct
  - New but differing MGA rules
  - Claims licensing and fairness compliance

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## How can these underwriting risks be best addressed?

- Complete pre-quote claims and underwriting audits to ensure the integrity of the submitted program data.
- Include one-on-one interviews with proposed lead MGA underwriters to determine their qualifications: Do not rely on short “bios.”
- Review Systems Compatibility Issues and factor this possible increased cost into the decision to go-forward.
- Complete and execute the Program Administrator Agreement, Reinsurance Treaty and Underwriting Guidelines prior to the inception of the program.

# How can these underwriting risks be best addressed?

Conduct on-site review sessions with MGA underwriters and management addressing:

- Adherence with the insurer's minimum Fidelity Bond and E&O insurance requirements.
- Underwriting Guidelines.
- Sub-producer qualifications and approval process.
- Qualitative Risk Selection Issues & Discretion
- If the policies are to be underwritten on an “admitted basis”, complete a detailed review of the in-force company filings with
  - Policy forms and optional or required endorsements
  - Program Administrator Agreement
  - Referral Process
  - Systems / IT training.
  - If applicable, claims management process.
- Monthly or Quarterly current account data reporting including specific information needed to monitor effective pricing changes at minimum on renewal business.
- Premium Audit and Cash Management

# How can these underwriting risks be best addressed?

Recurring areas that need to be clearly addressed:

- Uncollectible premiums;
- Payment of fines or penalties required as a result of state market conduct examinations;
- Roles and responsibilities, if any, of the lead reinsurer in managing the referral underwriting, claims management, or auditing;
- Financial rights and responsibilities of the MGA in the event that the financial and underwriting goals of the program are exceeded or not met.
- Ownership of renewal rights, branding, intellectual capital, marketing information, and actuarial data in the event the program is terminated.
- MGA's book-of-business financial objectives: Are they realistic, or do they encourage adverse selection in a softening market?

# Aligning Financial Goals...

Positive but not a panacea to all concerns...



- Traditional: No underwriting “skin in the game” ...
  - Flat commission (e.g. 20% or more)
  - Contingent Profit Commission
- Requiring the MGA to be a Risk-Taking Partner:
  - Sliding-Scale Commission Agreements
  - Rent-A-Captives (RAC)
  - Protected Cell Captives (PCC)
  - PORC’ s and DORC’ s

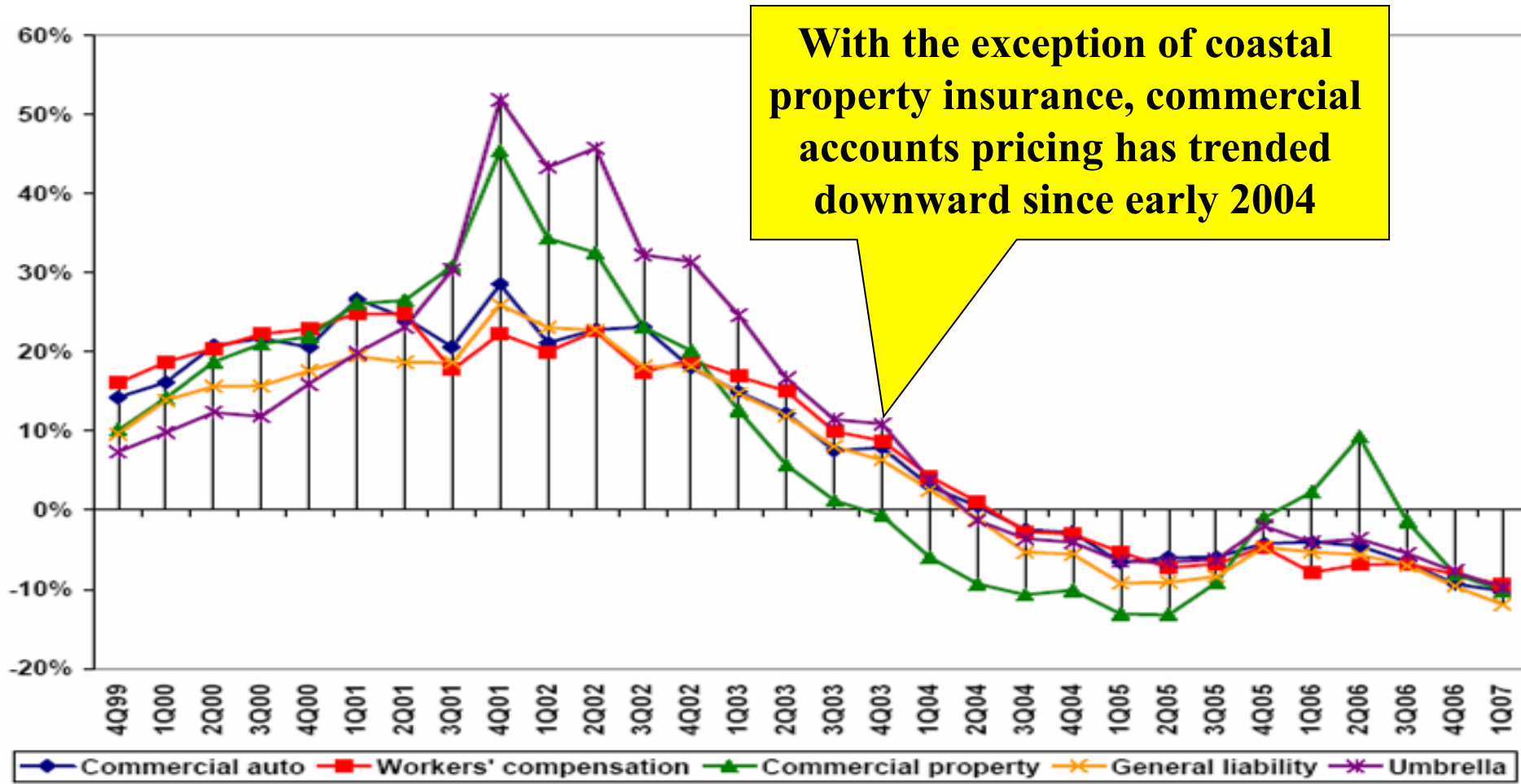
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- **Conclusions:** “Déjà vu all over again” in the near term future?

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# Conclusions: Will the Current softening market could encourage a “déjà vu all over again”?



## Conclusions: Many reasons for optimism...

- **Producer Licensing:** Many MGAs and insurers have improved their E&S and retail licensing
- **Increased use of internet-based underwriting systems:** Enabling lower transaction costs and improved compliance with Underwriting Guidelines and State filings.
- **“Fronting”:** Now a significant concern of insurers, regulators, and financial rating agencies.
- **Decreased traditional reinsurance purchasing:** Despite softening market recent reports show a decreasing trend in unaffiliated reinsurance purchasing by domestic insurers (See National Underwriter, *“U.S. Re Market Premiums Contract as Insurers Retain More Risk”*, 07/09/07.)

## Conclusions: Many reasons for optimism...

- **Decreased traditional reinsurance purchasing:** Despite softening market recent reports show a decreasing trend in unaffiliated reinsurance purchasing by domestic insurers (See National Underwriter, “*U.S. Re Market Premiums Contract as Insurers Retain More Risk*”, 07/09/07.)
- **Increasing number of requests for independent underwriting, claims, and operational audits:** Being initiated by the Boards, CEOs, Internal Audit senior officers, and senior underwriting executives at many insurers and reinsurers.

# Overview

Q & A

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