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# An Exploratory Examination of Two Models for the Distribution Of Property and Casualty Insurance

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## ABSTRACT

Many smaller insurance agents and brokers are losing ground as a result of sluggish economic growth. Much of the dwindling market share is due in part to an unstable and hostile economic market, negligible leveraging capability, and inability to adapt swiftly to constant social and economical changes. As more distribution networks form, the value of insurance professionalism is diminishing. In the insurance industry, the customer's need for proper insurance protection should be considered the single most important commitment by the firm. With the present drive to classify insurance products as a convenience good that can be purchased with minimum effort, the significance of the insurance product is being reduced to impulse shopping. Insurance offers a crucial safety net and must continue to be recognized as the remedy that prevents financial ruin. This paper reports the results of an exploratory study, which examines the specific growth strategy, mergers and strategic alliances, which responds directly to the business practices of the small insurance broker.

## 1 INTRODUCTION

Property and Casualty Insurance is marketed through many distribution systems. A consumer can buy insurance from the Direct Writer, mail marketing median, salaried employee of an insurance company, and an Independent Agent. In the United States the two major distributors of property and casualty insurance are the Direct Writers and the Independent Agents.

The Direct Writer is an exclusive agent that represents only one company while the Independent Agent places business through several companies. Determined by written premium, market share in the Property and Casualty industry is dominated by the direct writer. The fundamental cause is said to be the direct writer's favorable pricing. (Auden 2007). For the third consecutive year, both State Farm and Allstate respectively rank amongst the top 5 companies in the United States Property-Casualty Insurance Industry in 2006 as reporting record profitability. (Auden 2007).

On the other hand, the Independent Agent employs a more rigid approach to the underwriting process for writing some segments of business. For example, corporate leadership may establish a minimal standard. Imposed standards of liability limits could be required, which are higher than the compulsory limits required by the State Insurance Department. Also a formal method for establishing coverage is employed in the

independent agent's process, which involves a physical inspection of the property. Upon completion of the inspection, a list of critical recommendations is produced by the insurer that when complied with, yields a more favorable risk.

The consensus of many small insurance business owners is that they are under attack by a slew of unconventional competitors. Regardless of the triumph shared by both distributors over decades, a review of the literature divulges a rift between the small broker and more modern and novel business practices. Also, mergers and strategic alliances have increased (Niedzielski 1996). These mega-brokers participated in 140 merger and acquisition transactions in 1995 compared to 78 in 1994. The factors that are seemingly forcing consolidations are said to be in part, cuts in marketing and commission expenses from underwriting companies and volatile cycles with pricing (Niedzielski 1996).

As early as 1996, there was talk that new challenges were evolving for the independent agent and direct writer causing erosion to their market shares (Hamel & Prahalad 1996) The *National Underwriter* had begun to identify many of the problems associated with this attrition, citing ineffective leadership as a root cause of these difficulties. Also, *National Underwriter* asserted that many of these smaller companies suffer from short-term vision, an unyielding commitment to traditional ideas and core competency, and moreover they are more inclined to focus on short-term issues and results. (Hamel & Prahalad 1996).

Unlike large agencies, small business owners seem to undervalue the effectiveness of good leadership and how it stems from a clearly defined mission together with strategies that supports that mission followed by an effective implementation, monitoring, and an adjustment to those strategies being employed whenever required. The point to be emphasized here is that strong leadership is crucial to the evolution of business.

## 2 THE PROPERTY AND CASUALTY MARKET

Insurance is a risk management vehicle used to circumvent certain risk that can potentially result in a financial loss. Insurance is defined as "the equitable transfer of the risk of a potential loss from one entity to another in exchange for a premium." (Insurance 2008). When buying insurance, the purchaser benefits from the counsel of a licensed insurance

professional who helps the consumer understand the risk and transfer. This counsel does not always take place. For instance, there are more than 5 million Americans protected with Flood insurance (Are You Ready for a Flood 2007), which means that millions more are unacquainted with the notion of a potential flood risk and the options that are available for protection. Therefore, a consequence of using mail marketing medians is that the consultative aspect is lost creating a vulnerability to loss exposures. It seems that many consumers are unaware of the value that consultative selling brings to the process of selecting insurance products. The results of such indifference lead to underinsured, over insured and even uninsured consumers.

### **3 LITERATURE REVIEW**

Customer satisfaction relates to the expectations of a customer for a particular product and or service. The expectation of satisfaction begins before, during, and after a product is purchased and should be based on the customer's need. Shores (1988) makes a compelling case that any business must have the capacity to identify and measure product attributes, such as product performance, functionality and reliability, as they relate to the customer's need. Shores' belief is that a formal method for quality improvement is essential to the survival of a business in today's unstable and hostile economic markets. This method might help business owners understand why quality is important and how to make it work for them.

Porter (1998) examined the forces that drive industry competition and the key components that determine the intensity of those competitive forces. He described how those forces could lead to favorable results for a business. Porter suggested that a direct correlation exists between industry evolution and the need for the formulation of strategies. The simplest approach to analyzing evolution is to ask: Are there any changes occurring in the industry that will affect each element of structure? (p. 157). Porter gives specific steps that a firm can take to improve its position in a decline, such as minimizing investments or other actions that will raise exit barriers from the source, place strategic emphasis on market segments that will be favorable under decline conditions and create switching cost in these segments (p. 274). In summary, Porter provides a long-term foundation for managers to achieve superior profitability.

Aburdene (2005) suggested that middle management plays a primary role in the success of an organization. She attempts to dispel the myth that the success of an organization is the sole result of the CEO. She unequivocally declares that middle management is the source that creates real change.

*Competing for the Future* by Gary Hamel and C.K. Prahalad (1996) provides insight into business transformational systems having the capacity to reshape industries. Hamel and Prahalad consider the concept of change through an in-depth examination of business characteristics such as technology, life style, work style, regulation, and global geopolitics.

Hamel and Prahalad (1996) demand that every manager know the answers to such questions as: "How influential is my company in setting the new rules of competition with its industry? Is it regularly defining new ways of doing business, building new capabilities, and setting new standards of customer satisfaction? Is it more a rule-maker than a rule-taker within its industry? Is it more intent on challenging the industry status quo than protecting it?" (p. 1). Today, competition requires the pursuit of alternative distribution method. Hamel and Prahalad suggest that millions of dollars in revenue rest in future opportunities where alliances are being formed, expertise is being pulled together and experiments are being conducted in emerging markets. They imply that it will be those businesses capable of organizing resources inside and outside the company that will effectively capture disproportionate market shares resulting in new revenue streams and profit. Hamel (2002) addresses head on a company's unwillingness to change. He challenges each manager to ask: How much more revenue can our company squeeze out of its current business model? And, how different is our competitor's strategy from our own strategy?

Petzinger (1999) conveys the experiences of the entrepreneurs who are transforming the way that America does business. He demonstrates how old-style corporations are losing ground to trendsetting managers who are engaged in establishing collaborative workplaces, a value-added marketplace, and an economy swarming with opportunity.

Collins and Porras (2002) identified the historical development and best practices established and used by companies that have experienced longevity and prosperity. They provide compelling examples of how highly visionary companies, such as Boeing Corporation, use bold missions to stimulate progress. According to Collins and Porras, there is distinction between having goals and becoming committed to a huge and daunting challenge (p.94).

Jack Welch and Suzy Welch (2005) lay out a comprehensive plan to becoming a frontrunner in business. They discussed the significance and purpose of the mission statement and state that it must clearly define how a company intends to win in their business. The Welches also acknowledge that hiring the right people is brutally difficult; nevertheless, nothing is more relevant than having the "right" people to aid you with achieving your goals. Finally, They look at another route to growth – mergers. They suggest that a new business or new venture is far more challenging to run than an established one. They point out that there are three common mistakes companies make in the launch. First, they don't inundate start-up ventures with sufficient resources, particularly on the people front. Secondly, they fail to make the venture a big deal in terms of the promise and relevance of the new venture. Third, they limit the new venture's autonomy (p. 206).

### **4 RESEARCH STUDY PROBLEM STATEMENT**

Many smaller agents and brokers are losing ground as a result of sluggish economic growth. Much of this dwindling market share is due in part to an unstable and hostile economic market, negligible leveraging capability, and inability to adapt swiftly to constant social and economical changes. As more distribution networks form, the value of insurance professionalism is diminishing. In the insurance industry, the customer's need for proper insurance protection should be the single most important commitment by the firm. With the present drive to classify insurance products as a convenience good that can be purchased with minimum effort, the significance of the insurance product is being reduced to impulse shopping. Insurance is a crucial safety net for family and businesses and must continue to be recognized as the remedy that prevents financial ruin. Little is known about the impact on insurance customers emerging from the consolidation of these two entities within the industry. As a result, this is an area of research that demands attention.

## **5 RESEARCH METHOD**

The overall design of this study is exploratory in nature, which uses multiple methods. The study includes a review of insurance publications, face-to-face interviews with insurance professionals, insurance related websites, and the results of a field experiment. The use of more than one method triangulates the data to improve the validity of the study and facilitates greater a deduction from the results. The Dowling College IRB has reviewed and approved the procedures and instruments used in this study as it relates to human subjects.

### **Stage 1: Interviews With Ten Industry Professionals**

The semi-structured interview process permitted the researcher to first review the questionnaire responses and then further drill down during the face-to-face interviews. This allowed additional questioning to draw out the views of the insurance professionals. Specifically the areas being explored were (1) the state of the industry in the present day (2) whether there is a need to stretch the potential of small and mid-size companies, and (3) how open they are to innovation and the consideration of new ways in which to do business. For a full list of interview questions, please contact the 1st author. Following data collection, content analysis was used as the method for data categorization. The transcribed interviews were cross-examined by the researcher and each participant to ensure that the reoccurring themes were valid.

### **Stage 1: Subjects**

Ten human subjects participated in this study. To comply with the IRB requirements, the names and employers of the subjects will remain confidential. The ten subjects comprised four women and six men. Three were former or current agency owners; three subjects were marketing specialists; two were referred to as personal lines managers; one subject was an account executive, and one was a managing director.

### **Stage 2: Field Experiment**

*NetQuote*, an Internet based insurance shopping company (NetQuote Company History 2008) controls 40% of the market providing over 6 million qualified auto home, life, health, and business leads annually. Six of ten consumers will buy from a NetQuote Agent. For more information, please see: NetQuote.com. The participating agent selects the leads based on a specific criterion. NetQuote will then deliver the agent qualified consumer leads.

This stage of the study provided access to rich details about the purchasing habits and knowledge of insurance consumers. This stage explores the argument that separately, each distributor possesses its own strengths and weaknesses. An analysis of 100 leads was conducted. Fifty were homeowner consumers looking for competitively priced products and fifty were consumers seeking competitive automobile insurance.

## **6 RESULTS**

### **Stage 1: Results**

The results of the interviews are being presented in aggregate to protect the identity of the subjects' individual statements. The data suggest that mergers and or strategic alliances between these two distributors (independent and direct) have the capacity to enhance their financial strength and provide economic solutions for small businesses. However, this research is based on a small sample and is to be viewed only as an opening to a plan for future research.

Each survey participant compared and contrasted both the strengths and weaknesses of each business model. The majority of participants suggested that effective management of business relationships in the framework of synergism exceeds the sum of its individual parts. The discussions also suggested that fervor for traditional business standards exist with some small business owners based solely on nostalgia and is a diminutive basis for its stagnation. Overall, the consensus that many insurance professionals are open-minded to the prospect of mergers and or strategic alliances was vast.

### **Stage 2 Results:**

100 consumers were included in this stage. First, 95% of the leads that were used were insured with a direct writer. When asked why they were shopping their insurances, there was an overwhelming consensus focused on cost reduction. Despite the direct writer's competitive pricing a longing for a reduction in premium at the cost of protection persist.

The comparison of auto insurance quotations between the direct writer and the independent agent revealed price competitiveness in favor of the direct writer. In 2005, Allstate Insurance Company saved New York automobile policyholders an estimated \$50 million as a result of a reduction in the automobile premium averaging between 3 – 5%. In addition, State Farm Mutual also reduced its auto premium in 2005 in New York State by an average of 5%. Their savings were estimated at \$47 million – they also cut rates twice in the previous year. (Allstate Drives Forward with NY Auto Rate Cuts, 2005). In the 50 of 50 automobile quotes

provided, there was a zero success rate for the independents agents' ability to compete on the price point.

On the other hand, the analysis of homeowner insurance quotations revealed contrary results when compare to the automobile quotation sample. While the primary motive for consumer shopping was price, an additional cause for shopping homeowners insurance emerged. Many consumers were being non-renewed by their current insurer mostly for other underwriting reasons that were unrelated to losses. Under current NY law, carriers can legally non-renew 4% of policies in a rating territory for any reason. Last year, Allstate dropped 55,000 NY homeowner's policies. (Allstate to Comply with NY, 2007). While this is a practice used by all insurance companies, it is an ill-fated limitation for the direct writer to re-market the policy. Beyond the scope of what is subjectively defined by the direct writer's company as "an acceptable risk," this is a huge obstacle, which weakens the chance to maintain the lucrative relationship with the consumer. Like the direct writer, the independent agent also faces this challenge. The difference is that the independent agent has access to several insurance companies, which creates viable solutions for hard to place business. The independent agent also has the capability to write insurance in the Excess and Surplus Lines Market as a last resort.

The use of online vendors also posed challenges. It has the capacity to diminish the consultation approach to the underwriting process and undermines retention. For the majority of leads obtained from NetQuote, expedience was paramount for these shoppers. Many of the prospects had less than 30 days to replace their insurance policy and had no interest in having a discussion about coverage.

The results obtained from NetQuote further supports the notion that many consumers may be misinformed about the importance of having the *right* coverage. The results suggest that the perception of the consumer is that the process for buying insurance is superficial and one-dimensional. Of this sample, an overwhelming majority sought quick quotes based upon the insubstantial information obtained from a questionnaire they completed. As a result of an insufficient coverage review, when probing occurred, many of these consumers pushed back becoming frustrated and defensive. Another important observation was the belief of forty-five percent of the homeowners that their home valuation was based on market valuations; therefore they incorrectly concluded that due to the current state of the economy, their homes were now over-insured. The results of this stage support the author's assumptions for conducting this research.

## 7 ANALYSIS

Content analysis was used to condense the data from the in-depth interviews. The seven themes emerging from the data are presented here. They offer insight into the perceptions and related behaviors of insurance professionals.

### ***Open to The Idea of Coalitions***

Overall there was a consensus that coalitions have the capacity to strengthen industries and produce positive results. Many of the participants felt that the right circumstance could potentially simplify efforts toward reaching financial goals. The implication was that it might even be in the small business owners' best interest to pool resources, which leads to efficiency and reduction in duplicate efforts. Throughout the interviews a chief caveat to the prospect of building external business relationships lingered in the minds of the participants. All believed that prior to entering any type of partnership each partner must clearly understand the intentions of the other. A process that reveals specific facts about the individual goals of each and respective philosophies that could assist in establishing whether a shared vision exists. Furthermore, building a wide range of product and services ensures that the needs of the consumer are being met.

### ***Ethics in Business***

Business ethics was also a subject emphasized in all interviews. The participants concluded that ethical behavior is simply good business practice. They agreed that those companies that support ethics codes and compliance practices are stronger as a result. Clearly expressed was the belief that business ethics involves more than compliance with company policies, laws, and financial regulations. Many expressed that ethical agents will attract allies with similar beliefs. The result can be a cultural theme that advances ethical business practices throughout the industry. Solely integrating resources is not enough to establish an effective partnership; collaborative ethical philosophies are equally important.

### ***Some Form of Informal Referral Between Entities***

The results suggest that informal referrals between business owners already exist. It provides an opportunity to strengthen customer relationships. Many also expressed that merger or alliance tactics reduce overhead costs. Using the sales strengths and marketing niches of each distributor has a tendency to reduce marketing expenses and increase referral base business.

### ***Pretense of Innovation***

Smaller agents seem to view themselves as innovators, when they were clearly not. None of the business owners wanted to be labeled *traditionalists* yet many of their business operations had not undergone any significant change to its technology or business practice in a long period of time.

### ***No One Has Ever Included This strategy in a Formal Business Plan***

Although a number of small businesses prepared annual business plans, actively seeking opportunities through collaborations has never been considered. Remaining complacent with current target markets and old business strategies is the position taken by most of these business owners. They tend to remain loyal to traditional strategies even with declining production capacity.

***A Formal Plan is Developed and Communicated to The Staff***

Many small business owners have discovered that they were more effective in achieving their objectives when their plans were presented to their staffs. Similar to larger corporations, small business owners have started to present their business plans and tie individual performance objectives to results.

***The Plans Used to Sustain The Industry During Difficult Times Seem to Consistently focus on Internal Strategies Relating to Product.***

The businesses did target strategies to help insulate them from environmental risk, but often they were not enough. For instance, when asked what a broker would do during a soft market crisis many responded with focus on key products and their ability to strip down coverages that reduce costs for the consumer. This tactic was overwhelmingly used.

## **8 DISCUSSION**

Many small agents and brokers have over the years built successful companies based on a superior commodity that is essential to protecting the assets of its consumers. In doing so, they have cultivated great earning opportunities for themselves as well as their employees. Today, competition is fierce and as a result new and unique approaches to business expansion are essential in order to bring a target market closer to the business owner. Creating and maintaining relationships that satisfy organizational objectives require unique and cost effective ideas. Sustainable competitive advantage does not always rest with a pricing strategy. For those distributors who cannot compete with price, they must use other methods that can favorably impact their profit margin and revenue stream. For many of the major corporations and mid-sized producers, the solution to a rigid market has been mergers, acquisitions, or strategic alliance strategies. In most cases this has proven to be successful. However, in order for such strategies to be successful the partner members must equally commit to embracing and upholding common ideas and business practices. They each need to understand the relevance of great leadership, business ethics, and advanced business processes.

Two businesses coming together can embitter an otherwise good relationship. Without a proper structure or collaborative senior partners, failure becomes inevitable. Conversely, when done right, the outcome can be lucrative as well as lead to a comprehensive risk management service for the consumer. Strategic relationships can also leverage the unique skills of each firm; it forms efficiencies and creates a competitive force in the market place that is progressive, influential, and profitable. Due diligence is a critical business concept and is fundamental to any risk-based business. Unfortunately, in the insurance industry where due diligence is highly involved, consumers and the business owner could suffer great financial loss whenever this process is ignored. Due diligence is an area where many alternative distribution channels may fall short.

NetQuote is a successful company that provides the consumer the capability to comparison shop insurance products online.

This online process seems to work best for the price sensitive consumer. What is more, *saving money* is the message that is fundamental to NetQuotes' mission; their claim is "to provide guidance for consumer offering the best ways to save" (Company history about NetQuote, 2008). It is not to suggest that this process has no place in the insurance industry. In fact, it is an effective business strategy that matches up certain market segments with the right commodity businesses. Yet, do such practices push best practices within the industry?

Realizing improvements as a result of mergers and strategic alliances may be challenging for business owners without the support of their staff. Resisting change is anticipated and even a normal reaction for most. Effective leadership is critical. Announcing a merger can be stressful for employees. Owners must gain the acceptance of the employees. Leaders should establish a process that interfaces the staff with the strategy.

The knack to look back and assess what had gone wrong and what had been successful, is an exercise that can supply crucial information for making sense of how businesses operate effectively. A personal understanding of your target market's needs and desires is critical to the success of any business. Leadership must effectively advance cultures that communicate ideas and advocates boundaries bordered with respect and professionalism between co-workers and clients. With respect to the client, the organization must also insist that their unique objectives and interest be skillfully honored.

A leadership *mentality* must exist. Great leaders realize that every decision and every action matters. To build sustainable businesses great leaders must uphold the company's philosophy and consistently strive for growth. In organizations where a strong commitment to ethics exists, leaders are the greatest advocates of integrity. In large part, corporate America has begun to develop approaches that address this issue such as the institution of statements of corporate values, both formal and expressed codes of conduct, hotlines and board level ethics committees. Many senior managers agree that there are financial benefits to doing business ethically. Conversely, there is a financial cost to conducting business unethically. The value of ethics generally refers to things that are intangible. When one looks at corporations with a strong commitment to ethics it draw attention to the company's reputation. When integrity is discernible, the reputation is priceless. Unethical conduct by leaders tends to translate into an acceptable conduct by employees. If the leadership of an organization is not open and truthful at all times, this sends a resounding signal to the employees that the organization regards this behavior as acceptable.

## **9 CONCLUSION**

As this study is exploratory, the results provided preliminary conclusions that demand further study. The nature of mergers and strategic alliances is such that it has the propensity to offer a unique production strategy in an industry where the most valuable attribute is its sales capacity. Many of the small

business owners of these two leading distribution models have become complacent with organic growth, which have been averaging at about 2.8 percent annually in the past five years. Worse than that, The Insurance Information Institute (III) has recently forecast that 2008 will be the toughest environment for the property and casualty industry in both personal and commercial lines in 65 years. (Stipe, 2008)

With that said, a unique business strategy for small business owners has been explored. The greater significance of this

study and why such operations are being examined, leads to broader concerns within the industry. The small business owners of the insurance industry are at a critical juncture today in terms of identifying a long-term sustainability of earnings and returns.

**BIBLIOGRAPHY**

Will be provided upon request.