ALTERNATIVE MARKETS

Classification of Insurance Companies

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Insurance companies are classified according to five attributes:

1. Licensing Status
2. Place of Incorporation
3. Types of Business Written
4. Ownership
5. Distribution System

Licensing Status

A licensed (admitted) insurer is licensed to do business in a specific state. The carrier is subject to form and rate regulation by that state. Only licensed insurance agents and brokers can place business with admitted insurers.

An unlicensed (non-admitted) insurer is not licensed to operate in that state. All insurance placements must be done through a Surplus Lines Broker. Placements with non-admitted insurers are only allowed after three admitted markets have declined to write the risk.

Place of Incorporation (Domicile)

Insurers are classified as domestic, foreign or alien insurers. A domestic insurer is formed under the laws of a given state. A foreign insurer is formed under the laws of a state other than the state in which the risk is located. For example, a California insurer would be a foreign insurer for risks located in Nevada. Alien insurers are formed under the laws of another country.

Types of Business Written

A Standard Market Insurer offers coverage for risks that have typical exposures and average or better than average loss experience.

An Excess and Surplus Lines insurer offers coverage for risks with unique exposures and / or poor loss history and / or when coverage could not be placed in the standard market.

Ownership

The legal form of ownership refers to the person or persons who own an insurer. Insurers may be owned by outside stockholders, policyholders or the government.

Proprietary insurers exist to earn a profit for their owners. Proprietary insurers include stock companies and Lloyd's of London.

Stock insurers are corporations owned by the stockholders who invested in them. The stockholders elect a Board of Directors to oversee the operations of the company. The Board appoints officers to manage the daily operations of the company. Profits go to the stockholders in the form of dividends. Stock companies are the dominant form of insurer in the US.

Lloyd's of London is not an insurance company. It is a marketplace where risk is shared among individuals and corporations (known as names) which are members of underwriting syndicates. Each member is responsible for paying losses and pledge their personal or corporate assets to pay covered claims. Syndicate liability is several and not joint. Profits are paid to the members. Lloyd's is a major US insurer; however, their exact market share is unknown.

Cooperative insurers are owned by their policyholders and exist to provide low cost insurance. Mutual insurance companies, reciprocal companies, captive insurers and risk retention groups are cooperative insurers.

Mutual companies are corporations with no stockholders. When insurance is purchased from a mutual, the risk is transferred to the corporation. The policyholders elect a Board of Directors to oversee company operations and to appoint officers to manage day-to-day company functions. Excess profits are used to increase surplus and to pay policyholder dividends.

Reciprocal companies (Inter-Insurance Exchanges) are unincorporated associations. With a reciprocal, the risk of each member is transferred to all the other members. The company is managed by an attorney-in-fact, though they need not be a lawyer and can be a person, partnership or corporation. Excess profits are returned to the policyholders in the form of dividends.

Captive insurers are stock companies that insure their owner(s) risks. Captives pay a primary carrier a fee to "rent" their license to issue polices. Captives are formed in one state and but can write risks in other states. Because they are licensed in one state, they typically operate as a reinsurer of the primary insurer in the other states.

Risk retention groups are direct writing insurance companies formed by insureds engaged in the same industry or activity. They provide liability insurance only and are funded by their members. They are licensed in one state and can write in all states. They do not participate in state guarantee funds.

Pools are member-formed companies designed to provide low cost insurance and tailored risk management services. Pools can write all lines of coverage, but only in their state of domicile. Typically, a portion of the risk is shared by all pool members with the remainder being insured or reinsured. Members are issued a Memorandum of Coverage in lieu of a policy. Premiums are called contributions and are used to pay: pool operating expenses, claims, to increase surplus and when feasible, to pay member dividends. Regulatory oversight varies by state. Pools do not participate in state guarantee funds.

Government insurers are operated by the state and federal government to provide both insurance and reinsurance to fill needs not met by private insurers (e.g., assigned risk drivers) and / or to achieve collateral social purposes (e.g., flood insurance, mortgage insurance).

Distribution System

There are four distribution systems:

1. Independent Agency
2. Exclusive Agency
3. Direct Writer
4. Mixed System

Note, agents represent the insurer while brokers represent the policyholders.

Independent Agency System - Independent agents are independent contractors and represent several unrelated insurance carriers. They are paid on commission and own the renewal rights to the business they produce. Owning renewal rights mean that the producer can move their business to another insurer and the original insurer cannot solicit that business either directly or through another agent or broker.

Exclusive Agency System - Exclusive agents (captive agents) are independent contractors that represent one insurer, or a group of insurers under common ownership and management. They operate on commission and unlike independent agents, have no or limited ownership rights to their book of business. When the agency contract is terminated, the carrier owns the expirations.

Direct Writer System – Direct agents are employees, not independent contractors. Direct agents are compensated by salary, commission or a combination of both. Direct agents do not own their expirations.

Mixed System – Most insurers use only one distribution system, while some use more than one. When they use more than one distribution system it is called mixed distribution.