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So Your Startup Wants to Sell Insurance?

Agencies, MGAs and Carriers . . . oh my

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Selling insurance is complicated. Not impenetrable, but complicated. The sales process is sort of like a tangled piece of string—it's easy to see the beginning and end, but hard to figure out what's happening in the middle.

When you start untangling, you'll find prospect lists, telemarketing, direct mail, traditional marketing and web-based lead generators uncovering and enticing potential customers. You'll also find captive agents, independent agents or brokers, wholesalers, direct telephone sales, the Internet, affiliates, carriers and carrier-like entities selling various products.

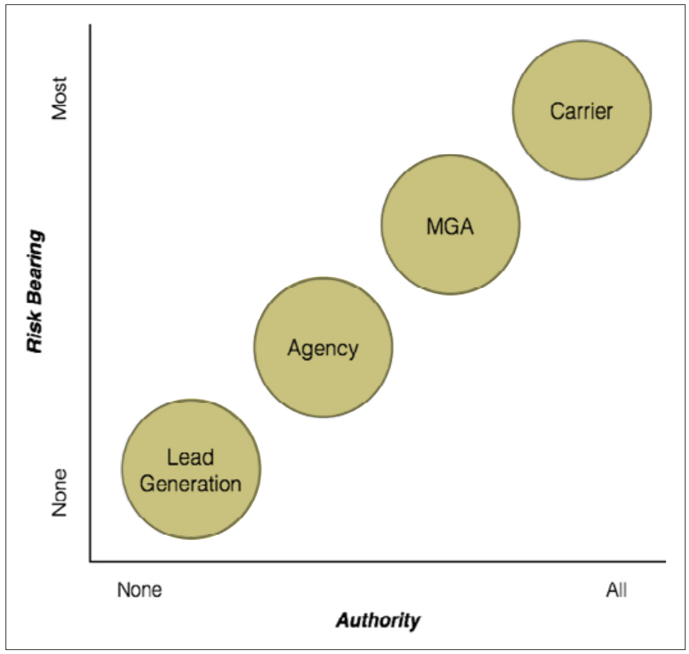
Some of these strategies work in coordination or create feedback loops—a customer sees a TV ad, which prompts them to submit a form online, which adds them to a direct mail list, that points them to an online aggregator, which puts them in touch with an independent agent selling insurance on behalf of a managing general agency ... as you can see, the number of distribution permutations is considerable.

However, at American Family Ventures, we classify insurance distribution startups using four groupings: lead generation, agency/brokerage, managing general agency (MGA) and carrier.

As pictured in Figure 1, the primary distinctions between participants in each group arise from the amount of insurance risk they bear and their control over certain aspects of the insurance transaction (for example, the authority to bind and underwrite insurance policies).

However, many other tradeoffs await insurance startups navigating among these four groups. If you consider the evolution of digital customer acquisition, including new channels like mobile-first agencies and incidental channels, choosing a niche becomes even more complicated.

Figure 1
Insurance Distribution Groups



In this article, I'll discuss some of the key attributes of each group, touching on topics relevant for startups new to the insurance ecosystem. Please note, in the interest of time and readability, this article is an overview. In addition, any thoughts on regulatory issues are focused on the U.S. and not legal advice.

LEAD GENERATION

Lead generation refers to the marketing process of building and capturing interest in a product in order to create a sales pipeline. In the insurance context, because of the high-touch sales process, this historically meant passing interested customers to agents or call center employees. Today, lead generation operators sell to a variety of third parties, including online agencies and digital sales platforms.

Let's consider a few key attributes of lead generation providers:

- **Revenue model**—There are a variety of lead-selling methods, but the most common is "pay per lead," where the downstream lead buyer (carrier or channel partner) pays a fixed price for each lead received. When pricing leads, quality plays a big role. Things like customer profile, lead content/data, exclusivity, delivery and volume all affect lead quality, which frequently drives the buyer's price sensitivity. As a lead generation provider, you'll generally make less per customer than others in the distribution chain, but you'll also assume less responsibility and risk.

- **Product breadth**—With the Internet and enough money, you can generate leads for just about anything. Ask people who buy keywords for class action lawsuits. However, startups should consider which insurance products generate leads at acceptable volumes and margins before committing to the lead generation model. Some products are highly competitive, like auto insurance, and others might be too obscure for the lead model to scale, like alien abduction insurance (which, unbelievably, is a real thing). Startups should also consider whether they possess information about customers or have built a trusted relationship with them—the former is often better suited to lead generation and the latter can facilitate an easier transition to agency/brokerage.

- **Required capabilities (partnerships)**—Lead generation providers need companies to buy their data/leads. Their customers are usually the other distribution groups in this article. Sometimes they sell information to larger data aggregators, like Axciom, that consolidate lead data for larger buyers. Generators need to show lead quality, volume and uniqueness in order to secure relationships with lead purchasers, but beyond that they don't typically require any special partnerships or capabilities.

- **Regulation**—While I won't go into detail here, lead generation operators are subject to a variety of consumer protection laws.

AGENCIES AND BROKERAGES

Entities in the agency/brokerage group (also called "producers") come in a variety of forms, including independent agents, brokers, captive agents and wholesale brokers. Of note, most of these forms exist online and offline.

Independent agents represent a number of insurance carriers and can sell a variety of products. Brokerages are very similar to independent agents in their ability to sell a variety of products, but with a legal distinction—they represent the buyer's interests, whereas agents represent the carriers they work for. Captive agents, as the name suggests, sell products for only one insurer. While this might seem limiting, captive agents can have increased knowledge of products and the minutiae of policies. Finally, some brokers provide services to other agents/brokers that sell directly to customers. These "wholesale brokers" place business brought to them by "retail agents" with carriers, often specializing in unique or difficult placements.

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An important difference between the lead generation group and the agency/brokerage group is the ability to sell and bind policies. Unlike the former, the latter sells insurance directly to the consumer and in some cases issue binders—temporary coverage that provides protection as the actual policy is finalized and issued.

Some attributes of agencies and brokerages:

- **Revenue model**—Agencies and brokerages generally make money through commissions paid for both new business and on a recurring basis for renewals. The amount you earn in commissions depends on the volume and variety of insurance products you sell. Commission rates vary by product, typically based on the difficulty of making a sale and the value (profitability) of the risk to the insurance carrier. Startups should expect to start on the lower end of many commission scales before they can provide evidence of volume and risk quality. Agents and brokers can also be fee-only (i.e. paid for service directly by the policyholder and receive no commission), but that's rare.

- **Product breadth**—Agencies and brokerages sell a variety of products. As a general rule, the more complex the product, the more likely the intermediary will include a person (rather than only software). Startups should also consider tradeoffs between volume and specialization. For example, personal auto insurance is a large product line, but carriers looking to appoint agents (more detail below) in this category usually have numerous options, including brick and mortar and online/mobile entities. Contrast this with a smaller line like cyber insurance, where carriers may find fewer, specialist distributors who understand unique customer needs and coverages.

- **Required capabilities (partnerships)**—Agencies and brokerages are appointed by carriers. This process is often challenging, particularly for startups, who are non-traditional applicants. Expect the appointment process to take a while if the carrier isn't familiar with your acquisition strategy or business model. Startups trying to accelerate the appointment process can start in smaller product markets (e.g., non-standard auto) or seek appointment as a sub-producer. Sub-producers leverage the existing appointments of an independent agency or wholesaler in exchange for sharing commissions. You could also apply for membership in an agency network or cluster—a group of agents/brokers forming a joint venture or association to create collective volume and buying power.

- **Regulation**—Agencies and carriers need a license to sell insurance. Each state has its own licensing requirements, but most involve some coursework, an exam and an application. As we've recently seen with Zenefits, most states have a minimum number of study hours required. There are typically separate licenses for property, casualty, life and health insurance. Once licensed, many states have a streamlined non-resident licensing process, allowing agencies to scale more quickly.

MANAGING GENERAL AGENCIES

A managing general agent (MGA) is a special type of insurance agent/broker. However, unlike traditional agents/brokers, MGAs have underwriting authority. This means that MGAs are (to an extent) allowed to select which parties/risks they will insure. They also can perform other functions ordinarily handled by carriers, like appointing producers/sub-producers and settling claims.

Startups often consider setting up an MGA when they possess data or analytical expertise that gives them an underwriting advantage vs. traditional carriers. The MGA structure allows the startup more control over the underwriting process, participation in the upside of selecting good risks, and influence over the entire insurance experience (e.g., service and claims).

We've recently witnessed MGAs used for two diverging use cases. The first type of MGA exists for a traditional use case—specialty coverages. They are used by carriers who want to insure a specific risk or entity, but don't own the requisite underwriting expertise. For example, if an insurer saw an opportunity in coverage for assisted living facilities, but hadn't written those policies before, they could partner with an MGA who specializes in that category and deeply understands its exposures and risks. These specialist MGAs often partner closely with the carrier to establish underwriting guidelines and roles in the customer experience. Risk and responsibilities for claims, service, etc., are shared among the two parties.

The second type of MGA is a "quasi-carrier," set up through a fronting program. In this scenario, an insurance carrier (the fronting partner) offers the MGA access to their regulatory licenses and capital reserves to meet the statutory requirements for selling insurance. In exchange, the fronting partner will often take a fee (percentage of premium) and very little (or no) share of the insurance risk. The MGA often has full responsibility for product design and pricing and looks and feels like a carrier. They underwrite, quote, bind and service policies up to a specific amount of written authority. These MGAs are often set up when a startup wants to control as much of the insurance experience as possible, but doesn't have the time or capital to establish themselves as an admitted carrier.

Some important characteristics:

- **Revenue model—**MGAs often get paid commissions, like standard agencies/brokerages, but also participate in the upside or downside of underwriting profit/loss. Participation can come in the form of direct risk sharing (obligation to pay claims) or profit sharing. This risk sharing functions as "skin in the game," preventing an MGA from relaxing underwriting standards to increase commissions, which are a function of premiums, at the expense of profitability, which is a function of risk quality.

- **Product breadth—**MGAs of either type often provide specialized insurance products, at least at first. The specialization they offer is the reason why customers (and fronting partners) agree to work with them instead of a traditional provider. That said, you might also find an MGA that sells standard products, but takes the MGA form because it has a unique channel or customers and wants to share in the resulting profits.

- **Required capabilities/partnerships—**Setting up an MGA generally requires more time and effort than setting up an agency/brokerage. This is because the carrier vests important authority in the MGA, and therefore must work collaboratively with it to build trust, set guidelines, determine objectives and decide on limits to that authority. Startups looking to set up an MGA should be ready to provide evidence they can underwrite uniquely and successfully or have a proprietary channel filled with profitable risks. Fronting often requires a different process, and the setup time required varies based on risk participation or obligations of the program partner. Startups should also carefully consider the costs and benefits of being an agency vs. MGA—appointment process difficulty vs. profit sharing, long-term goals for risk assumption, etc.

- **Regulation—**MGAs, like carriers, are regulated by state law. They are often required to be licensed producers. Startups should engage experienced legal counsel before attempting to set up an MGA relationship.

Carriers

Insurance carriers build, sell and service insurance products. To do this, they often vertically integrate a number of business functions, including some we've discussed above—product development, underwriting, sales, marketing, claims, finance/investment, etc.

Carriers come in a variety of forms. For example, they can be admitted or non-admitted. Admitted carriers are licensed in each state of operation, non-admitted carriers are not. Often, non-admitted carriers exist to insure complex risks that conventional insurance marketplaces avoid. Carriers can also be "captives"—essentially a form of self-insurance where the insurer is wholly owned by the insured. Explaining captives could fill a separate article, but if you're interested in the model you can start your research here.

Attributes to consider:

- **Revenue model—**Insurance carrier economics can be complicated, but the basic concepts are straightforward. Insurers collect premium payments from insureds, which they generally expect to cover the costs of any claims (referred to as "losses"). In doing so, they profit in two ways. The first is pricing coverage so the total premiums received are greater than the amount of claims paid, though there are regulations and/or market pressures that dictate profitability. The second is investing premiums. Because insurance carriers collect premiums before they pay claims, they often have a large pool of capital available, called the "float," which they invest for their own benefit. Warren Buffet's annual letters to Berkshire Shareholders are a great source of knowledge for anyone looking to understand insurance economics. Albert Wenger of USV also recently posted an interesting series that breaks down insurance fundamentals.

- **Product breadth—**Carriers have few limitations on which products they can offer. However, the products you sell impact regulatory requirements, required infrastructure and profitability.

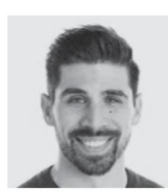
- **Required capabilities/partnerships—**Carriers can market and sell their products using any or all of the intermediaries in this article. While carriers are often the primary risk-bearing entity—they absorb the profits and losses from underwriting—in many cases they partner with reinsurers to hedge against unexpected losses or underperformance. There are a variety of reinsurance structures, but two common ones are excess of loss (reinsurer takes over all payment obligations after the carrier pays a certain amount of losses) and quota share (reinsurer pays a fixed percentage of every loss).

- **Regulation—**I'll touch on a few concepts, but carrier regulation is another complex topic I won't cover comprehensively in this article. Carriers must secure the appropriate licenses to operate in each country/state (even non-admitted carriers, who still have some regulatory obligations). They also have to ensure any capital requirements issued by regulators are met. This means keeping enough money on the balance sheet (reserves/surplus) in order to ensure solvency and liquidity (i.e. maintaining an ability to pay claims). Carriers also generally have to prove their pricing is adequate, not excessive, and not unfairly discriminatory by filing rates (their pricing models) with state commissioners. Rate filings can be "file and use" (pre-approval not required to sell policies), or "prior approval" (rates must be approved before you can sell policies).

CONCLUSION

In this overview, I did not address a number of other interesting topics, including tradeoffs between group choices. For example, you should also consider things like exit/liquidity expectations, barriers to entry, and creating unfair advantages before starting an insurance business. Perhaps I'll address these in a future article. However, hopefully this brief summary sparks questions and new considerations for startups entering the insurance distribution value chain.

I'm looking forward to watching thoughtful founders create companies in each of the groups above. If you're one of these founders, please feel free to reach out!



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