The New MGU Model: Opportunities for Actuaries
IET-11: Distribution in the 21st Century

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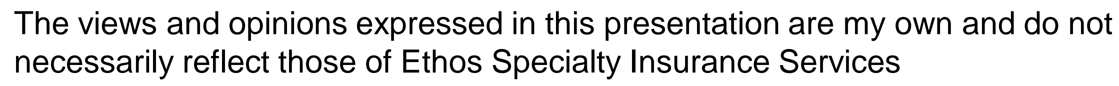
Emily Gilde, Ph.D, FCAS, MAAA
Chief Actuary

Disclaimer



Introduction

ETHOS

- After 20+ years working for a primary insurer, I recently moved to a new MGA, Ethos Specialty Insurance Services, to be their first Chief Actuary
- I was intrigued by the opportunity given the recent focus on the MGA space, including the goal of some MGA's to become Insurance-Companies-With-No-Capital.
  - Not new: MGA underwriting expertise in particular classes, emphasis on technology and innovation, writing for multiple carriers
  - New: Actuarial and ERM capabilities, HR/Audit/Compliance functionality, stronger technology push, use of non-traditional capital
- Initially I had thought of this new breed of MGA's as "disruptive" to the traditional insurance model because of their growing use of alternative capital
- I've quickly come to see that the new MGA business model is not disruptive; rather it has the potential to increase the efficiency with which traditional carriers can deploy existing insurance products to customers and to create and sell new ones.
- Such capability benefits the whole industry.
- The MGA value proposition extends to many areas of the insurance supply chain, including underwriting, distribution, pricing, data analytics, and technology.
- My talk will focus on the different ways an MGA provides value and the important role that actuaries have in the new MGA/MGU model

The MGA Market

ETHOS

- What does an MGA do?
  - Provides outsourced underwriting capabilities for an insurer to get into a space where they don't have expertise
  - Unlike an insurance agent or broker, an MGA usually has underwriting authority as well as binding authority
  - MGA's sometimes administer claims; in these cases, they are sometimes called MGU's, although mostly the terms are interchangeable

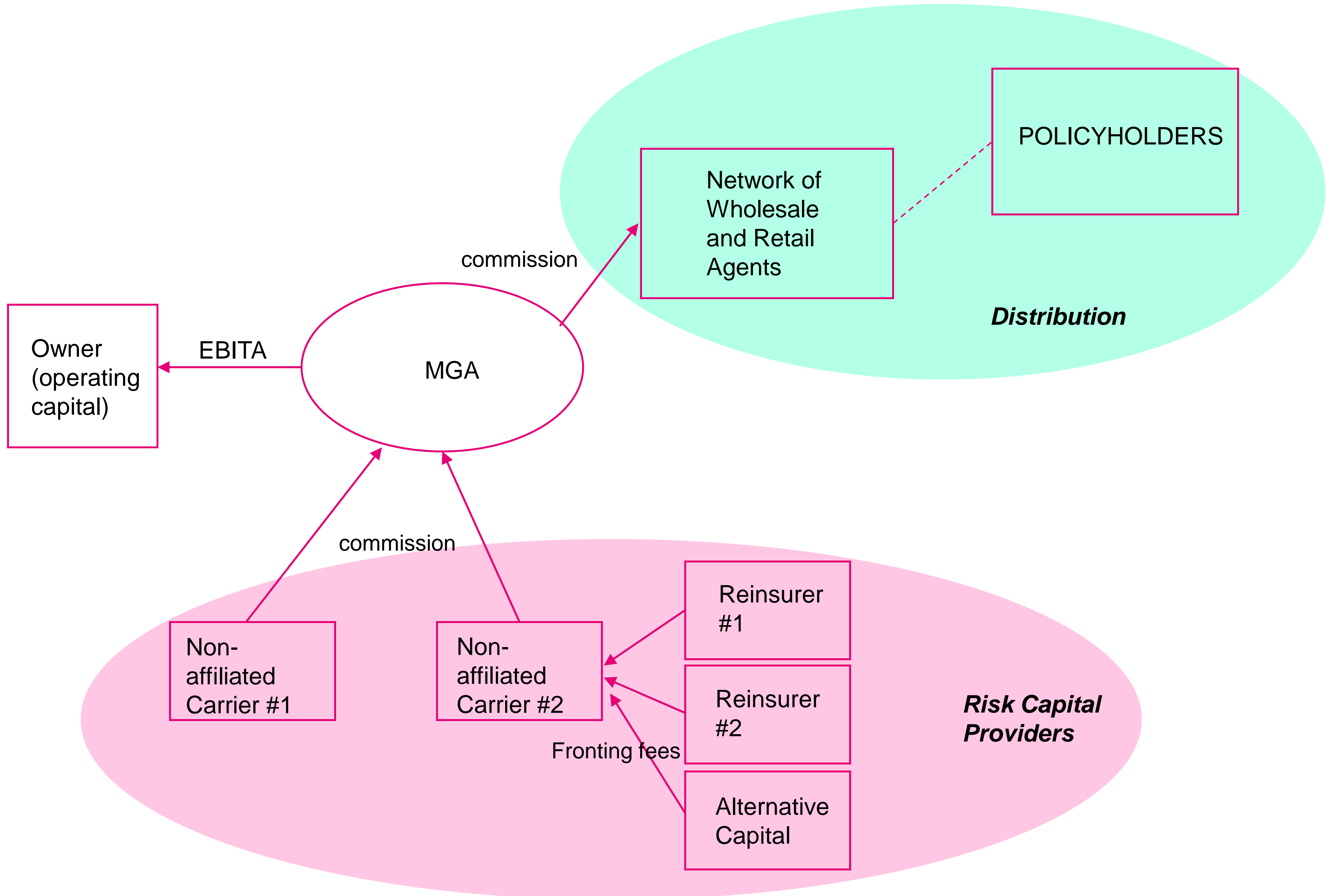
- For reporting and analysis purposes, Conning divides MGA produced premium into affiliated, non-affiliated, and crop
  - Affiliated: Premium is generated by an MGA that the insurer owns or controls
  - Non-affiliated: Premium is generated by an MGA that the insurer does not own or control
  - Crop: Includes premium generated by MGA's that participate in the government multi-peril crop insurance program

- MGA market is growing[1]
  - Excluding crop premium and premium written on behalf of the California Earthquake Authority, MGA direct written premium increased from $24.8B in 2013 to $35.1B in 2016.
  - Due to the way in which companies are required to report MGA premium, these figures are underestimates; according to Conning, $40B may be a better estimate of non-crop, non-earthquake MGA premium for 2016
  - MGA premium growth has outpaced overall growth in overall commercial lines premium and now represents approximately 17% of the total, up from less than 5% in 1999.

- The MGA business model works best at insuring specialized "niche" type risks; for several reasons MGA's are often able to originate and underwrite this business "better, faster, and cheaper" than carriers

Notes: [1] "Property-Casualty Managing General Agents: Growth Continues but No Escape from the Soft Market," Conning 2017. Used with Permission.

Example: Simplified Ownership-Insurance Distribution Chain for a non-affiliated MGA



One fundamental way that an MGA adds value – turns fixed costs into variable

ETHOS

- Highly specialized or "niche" insurance lines require specialized resources. Examples include insurance for schools or religious programs, paintball facilities, exotic animals, rare books, coin collections, etc.
- Can be more efficient for one or more carriers to pay MGA a commission percentage (a variable expense) to write the business rather than for each carrier to acquire specialized resources on its own (incurring large, upfront fixed costs)
  - Insurer may not want to write a great deal of this business and could not justify hiring an underwriter with the required specialized knowledge
  - Writing this business may also require specialized tools or third party data. As a center of excellence, MGA may be able to buy the resources once, incorporate into its underwriting, and benefit a number of participating carriers.
  - Going the MGA route provides carrier with an exit strategy if it changes its mind about writing the business; avoids reputational costs of having to shut down an internal business unit
- These considerations help explain why MGA may be able to underwrite certain types of specialized business at a lower fixed cost than a carrier

Case Study: Maritime Program Group

- Provides "coverage in motion" insurance for wide range of boat related risks. Examples include:
  - Recreational marine commercial products: Boat dealer insurance, boat yard insurance, marina insurance, yacht broker insurance, sailing school insurance, and more
  - Boat and yacht products: Insurance for captained yachts valued over $1M USD, Sportfishing boats, insurance for owners who live-aboard their boats, Houseboat insurance, and more
  - Inland marine
  - Ocean marine
- Team Bio's reflect deep specialization
  - Many years of experience as marine underwriters
  - Past experience working on schooners and commercial vessels
  - Former safety instructor for the American Boat and Yacht council
  - Former delivery captain and yard manager for sailing yachts
  - Certified Marine Investigator
  - Life-long boating and sailing enthusiasts

Using an MGA can improve level and stability of carrier's underwriting profits

ETHOS

OPTION 1: Carrier hires underwriting resources at a fixed cost of $500,000 per year

	DWP	prob	LR	FC	Underwriting Gain Carrier	Underwriting Gain MGA
	3,000,000	10%	50%	500,000	1,000,000	-
	3,200,000	20%	60%	500,000	780,000	-
	3,400,000	40%	75%	500,000	350,000	-
	3,600,000	20%	35%	500,000	1,840,000	-
	3,800,000	10%	60%	500,000	1,020,000	-
Expected	3,400,000			500,000	866,000	-
Wtd Stdev	244,949			-	614,292	-
CV					71%	0%

Option 2: Carrier pays MGA a fixed commission of 13.5%

	DWP	prob	LR	commission	Underwriting Gain Carrier	Underwriting Gain MGA**
	3,000,000	10%	50%	13.50%	1,095,000	5,000
	3,200,000	20%	60%	13.50%	848,000	32,000
	3,400,000	40%	75%	13.50%	391,000	59,000
	3,600,000	20%	35%	13.50%	1,854,000	86,000
	3,800,000	10%	60%	13.50%	1,007,000	113,000
Expected	3,400,000				907,000	59,000
Wtd Stdev	244,949				603,215	33,068
CV					67%	56%

**Assumes FC=$400,000 for the MGA

- Option 1: Carrier hires an underwriting team for $500,000 per year. Expected underwriting gain is $866,000
- Option 2: Carrier engages MGA who is able to acquire underwriting resources for $400,000. The parties negotiate a commission of 13.5%. The MGA earns $59,000 per year, while the carrier earns $41,000 more income per year and has reduced earnings volatility
- Value proposition: As long as the MGA's costs are lower than the carrier's, the MGA adds efficiency to the distribution chain
  - Efficiency gains are split between the parties (based on negotiation strength)
  - Converting fixed costs to variable reduces the carrier's earnings volatility

Another MGA value-add: product innovation

ETHOS

- Historically MGA’s have played an important role in product innovation.

- Several reasons for this
  - Closer to retail/wholesale agents and changing demands for specialized coverage
  - Operationally nimble
  - Most important: Entrepreneurial mindset. MGA’s are specifically charged to find new ideas and people with specialized skills

- A few recent examples
  - Active shooter liability: Need for an insurance policy covering this has arisen due to the duty of care held by various organizations. The MGA’s website describes the policy terms and includes a lot of educational material. The MGA also has partnered with law enforcement to provide active shooter training – to NYC restaurant owners and employees, for example.
  - Personal cyber policy that attaches to Homeowners: Developed by an MGA, the product extends coverage beyond typical identity theft to include cyber bullying, extortion, wire transfer fraud, and breach notification costs. Also covers legal expenses if you are sued for liability of a data breach or accused of cyber bullying.
  - Insurance for pizza and deli delivery services: This MGA developed product was created for small companies who may be making deliveries without a commercial auto policy. Owners may not realize their personal auto policy wouldn’t cover deliveries. Coverage tailored specifically to these operations, making the policy more affordable.

MGA's can also enhance capital efficiency

ETHOS

- Capital available to MGA's currently is plentiful; can pick and choose best paper to support different Programs, based on the carrier's preferences and risk appetite
- MGA can easily accommodate alternative capital that desires to get closer to the sources of distribution – retail and wholesale agents
- In recent years, the ready availability of capital has allowed MGA's to focus on and develop capabilities to replicate all the other functions of a successful insurer -- strengthening distribution relationships, getting closer to the customer, building actuarial and claims handling capabilities, and innovating products and technology.
- MGA's flexible use of capital provides added stability to the industry that should lower long run capital costs and help lessen the underwriting cycle

Example: Volante Global Limited

- MGA launched at the end of 2017 with goal of underwriting a wide range of specialist P&C portfolios such as professional and financial lines, motor, space & aviation and marine & energy
- Established to be a conduit to risk for alternative capital providers; already has significant investment from Nephila Capital
- Volante CEO recently articulated this vision of MGA-as-Insurer:

  "Volante intends to underwrite for its Carriers as a virtual division of them. We are setting our foundations and framework to operate as a Company or Syndicate underwriting institution, with full adherence to Lloyd's minimum Standards from day one – with full actuarial, risk and claims management functions enabling our trading discipline and rating adequacy…"[3]

[3]www.artemis.bm/blog/2017/12/20/nephila-backs-volante-as-it-aims-to-be-a-global-mga-for-alt-capital

"Giving away the pen"

ETHOS

- MGA's are not new and have a past that is dotted with some spectacular underwriting disasters
- Problems from 1980's through early 2000's in particular resulted in several insurer insolvencies linked to MGA's; three egregious examples:
  - Transit Casualty Insurance Company
  - Unicover Managers, Inc.
  - Legion Insurance
- In nearly all cases, an overreliance on MGA's is just one issue that led to problems. Typically the carrier was also to blame – rapid expansion, extensive reinsurance, systemic under-pricing, under-reserving, reckless management, etc.
- 2002 NAIC Managing General Agents Act strengthened accountability for both MGA's and carriers
  - Adopted by all states except New York
  - Establishes MGA licensing requirements
  - Sets out required provisions for the MGA contract with the carrier
    - Specific underwriting guidelines required (to limit risk taking)
    - Prohibition against MGA binding treaty reinsurance on behalf of the carrier
  - Duties of insurers
    - If MGA sets loss reserves, these must be evaluated by the carrier's actuary
  - Examination Authority: Acts of the MGA are considered to be the acts of the insurer on whose behalf it is acting.
- In recent years MGA's and carriers have also tried to align incentives by structuring MGA compensation using some type of profit sharing, such as a sliding scale commission.

Sliding scale commissions can be costly

ETHOS

- Most common form of profit sharing used by MGA's

- Returning to prior example, suppose instead of a flat 13.5% commission, the MGA is compensated using a schedule that depends on loss ratio (see box)
  - Comparing Option 2 with Option 3 shows that substituting a sliding scale commission reduces earnings volatility for the insurer (by reducing or eliminating commission expense in bad loss years)
  - Since the MGA has taken this underwriting volatility onto its balance sheet, it will demand a higher average commission. In Option 3 the average commission is 14.5%, resulting in a reduction in the carrier's expected underwriting gains compared to Option 2
  - Setting aside incentive effects, this sharing of underwriting risk may or may not add value, depending on the market power and relative risk preferences of the parties

Option 3: Carrier pays MGA a variable commission that depends on the loss ratio

					Underwriting Gain	
	DWP	prob	LR	commission	Carrier	MGA
	3,000,000	10%	50%	25.00%	750,000	350,000
	3,200,000	20%	60%	20.00%	640,000	240,000
	3,400,000	40%	75%	0.00%	850,000	(400,000)
	3,600,000	20%	35%	30.00%	1,260,000	680,000
	3,800,000	10%	60%	20.00%	760,000	360,000
Expected	3,400,000		60%	14.50%	871,000	95,000
Wtd Stdev	244,949				234,011	479,824
CV					26.9%	505%

Sliding Scale

LR	Commission
35%	30%
50%	25%
60%	20%
75%	0%

Sliding scale commissions are inefficient

ETHOS

- Operationally complex and expensive to manage
  - Typically requires interim payouts over multiple years as the IBNR emerges
  - May include complicated carry-forward provisions
  - Sometimes contracts are not kept up to date and are unclear or inconsistent
  - Can require multiple FTE to manage accounting

- Business sometimes enters sliding scale arrangements without a good understanding of the expected cost
  - Determining the expected cost requires actuarial loss modeling; this takes time, and there may not be enough data
  - In the heat of negotiations, contract features such as loss caps may be added without understanding the long term negative impact on the carrier's expected profitability

- Not clear that sliding scale commission provides meaningful incentives to take the right risks.
  - Like the "alpha" in a stock return, underwriter skill is just one component of the loss ratio. Arguably, key drivers in loss ratio movements over time are randomness (process risk) and underwriting cycle (systemic risk)
  - Sliding scale unlikely to have curbed the excesses associated with past MGA failures

- Problem becomes worse the smaller and less mature the book of business over which profit sharing is calculated.
  - Profit sharing becomes mostly dollar trading driven by random loss outcomes that are outside of the underwriter's control
  - To the extent that loss ratio volatility is diversifiable within a carrier's portfolio, it is inefficient for the carrier to pay the MGA to shoulder it

- Is the profit sharing "cure" worse than the problem it is trying to solve?

What does the "new MGA" model need to do to be successful?

ETHOS

- Keep costs down: Key to value add is being able to provide services to insurers at a lower cost than they could do it themselves
- Do this while competing with efficient technology and third party data
  - Employ easy-to-use agent portal
  - Develop ability to quote and issue policies quickly (less than 24 hours)
  - Incorporate 3rd party data to underwrite, price, and monitor risks
- Continue to cultivate new distribution sources and to bring new product ideas to market
- Improve compensation structure to be simpler to administer, clearer, and more effective in aligning incentives
- Strengthen risk management capabilities
  - Develop actuarial capabilities for evaluating new opportunities, build technical pricing models, and monitor underwriting performance/rate adequacy
  - Implement an ERM framework for the MGA
- Shane Doyle, former CEO of DUAL International: "…MGA's are an increasingly acknowledged part of the landscape. A genuine focus on structure, talent, transparency, information management, and quality of services means that the leading MGA's are no longer as different from insurers as they once were; the sector has passed through its troubled childhood and is maturing in a responsible, intelligent and valuable member of its industry…the relentless focus of an MGA must be on delivering profitability to its capacity providers…"[4]

4"MGA's – what are they good for," September 2014, Reactions, p.4.