THE MGA MODEL: CAN IT SURVIVE A HARD MARKET?

By

Wayne H. Carter, III, CPCU, ARM

***About the Author**: Wayne Carter is President and Chief Executive Officer of Target Capital, headquartered in Avon, Connecticut, which is one of the nation's fastest growing Managing General Underwriters and aggregators of specialty insurance programs.*

***Abstract**: The market role and image of Managing General Agents (MGAs) have long been controversial, particularly from the vantage point of their risk-bearing partners. In tracing the evolution of those relationships, Mr. Carter suggests ways in which MGAs can obtain and restore the confidence of the insurance and reinsurance community they serve.*

The Evolution of the MGA

As an insurance delivery method, managing general agency business models have roots, which date back to the early part of the 20th century. The life insurance industry was the early innovator in using managing general agents to deliver products. The practice caught on somewhat later in the property and casualty industry, but did not gain broader acceptance in the admitted marketplace until the early 1970's. Throughout the 70's, there were moderate gains in the development of admitted property and casualty programs[1].

[1] "Property and casualty programs" for the purposes of this article are defined as portfolios of homogeneous risk exposures, which are linked by commonality of class (lawyers) and line(s) of business (professional liability, general liability). In the property and casualty industry, program business is driven by class of business and, in many cases, is further refined by a single line of business although many programs are multi-line. Program business may be formed around an affinity group such as a trade association, but again, many are not.

However, such programs were predominantly confined to more traditional multi line or national carriers, who exercised a great deal of control over "the pen".

In the early years, retail agents and brokers dominated the P&C program business. As more carriers began to realize that specialization and homogeneity of class produced better underwriting results, the program approach began to grow. Spread of risk was accomplished by broader geographical penetration and the program business began to take on a national flavor.

It was not until the latter part of the 1980's that the P&C industry saw the proliferation of managing general agents. The hard market of 1984 and 1985 slowed the momentum of the late 70's and early 80's, as reinsurers and carriers retrenched. However, as results improved and capacity increased, the risk bearers' hunger for premium created a spawning ground for the MGA business model. Those programs that survived the mid 80's hard market emerged stronger, larger, and more profitable. Their success helped strengthen the belief that the program approach in the P&C industry was a panacea.

As industry leaders began to predict a market turn in the early 1990's, capacity continued to grow and prices continued to fall. The program approach gained in popularity as a way to better manage underwriting results. Reinsurers, not wanting to miss any opportunity to attract premium, found the MGA business model, using non-risk-taking fronts, as a great way to get their piece of the primary market. The growth of fronted programs was unprecedented, and the pressure on the more traditional and predictable approach to the program business mounted.

As we approached the year 2000, the competition for premium began to take its toll. Even in longer tail business, it was apparent that prices had to increase; yet there was still significant capacity within the industry. Reinsurers and primary carriers alike were reluctant to raise prices and risk losing market share. Many MGA business partners exacerbated the problem because the perpetuation of their MGA operations depended upon the staying power of their risk-bearing partners. The pressure to continue to push the market down was significant.

Current Market Conditions

In the year 2000, the property and casualty industry lost $30 billion dollars and recorded the second worst period of underwriting loss in the last 26 years. Only 1993 produced poorer underwriting results when the industry lost $36 billion, $15.5 of which was attributable to Hurricane Andrew. In 2000, the P&C industry combined ratio hit 109.6% and the after-tax ROE was 6.5%. The medical malpractice segment experienced a combined ratio of 134%, 14 points above its break-even mark, which has further escalated to an estimated 139% in 2001.

A favored tactic of risk bearers given these market conditions is to centralize underwriting authority. Internally, primary carriers accomplish this by reducing authority levels for field underwriters. For MGAs, this tactical approach threatens the existence of the business model itself as it relates to their relationships with traditional admitted carriers. Under that scenario, the MGA's role is reduced to that of a distribution conduit in a hostile expense environment. With the advances in technology, there is an additional incentive for the primary carrier to circumvent the MGA altogether.

For those MGAs focused on fronted programs, the pressures are different, but no less intense. Reinsurers are now requiring the fronting carrier, as well as the MGA, to have a risk-bearing stake in their programs. In many cases commissions are falling as much as 30%, and reinsurers are demanding price increases as a condition for continuing on many treaties.

Because of the significant turmoil in the marketplace, more program business is in play now, than ever before. Resulting workloads on primary underwriters, as well as reinsurance underwriters, will delay the fall-out within the MGA arena. Many treaties have been extended, while still others have unexpired terms remaining on multi-year arrangements. For those MGAs caught unaware, or who refuse to read the tea leaves, the consequences can be dire.

Many stand-alone MGAs have been ill equipped to deal with existing realities, let alone what is to come. Their organizational structure and culture make it difficult for them to tighten their belts. Most do not drive margins of 30% to their bottom lines, so a 30% commission reduction can put them out of business. Another contributing factor stems from their concentration in one class or line of business. If that line is unprofitable for their risk-bearing partners, the golden goose is dead. Even if the MGA is able to obtain reinsurance terms, often it won't be able to live with them.

The Rules Have Changed

In the early 90's, a few primary carriers began to put greater demands on their MGA business partners. A new set of underwriting and pricing standards helped create the concept of the Managing General Underwriter or MGU. If a risk bearer were going to give its pen to an outside party, it wanted that party to be focused on underwriting, not sales. Because capacity was so readily available and the pursuit of premium was so dominant, that concept did not obtain widespread acceptance or recognition. Those who built their organization with the MGU concept in mind found it exceedingly difficult to differentiate themselves based on their knowledge and experience. Often times, MGAs without the requisite knowledge and experience were not at a competitive disadvantage, as qualitative barriers to entry did not exist. Finding capacity to support a program idea was sometimes easier without the baggage of prior loss data. Many underwriters were inclined to see and hear what they hoped was true, rather than respond to data that painted a different picture.

As we approach 2002, underwriters are demanding data, demanding expertise, and demanding a business plan, which will guarantee an underwriting profit. The ability to differentiate based on knowledge and expertise has moved to the forefront, and has now become requisite to succeed as an MGA/MGU.

With capacity shrinking at the primary level, as well as the reinsurance level, we are experiencing market conditions that many MGAs have never seen. Leverage within the industry has shifted decidedly away from the brokerage community into the arms of the underwriters. Risk-bearers now dictate terms and conditions, require verifiable empirical evidence as to the viability of a program, and have raised the premium threshold to $15 million or higher before they will entertain program opportunities. Fronting arrangements are disappearing, smaller primary carriers are held to more stringent standards by their reinsurers, and many primary carriers with weak financials are either forced out of competition or leave on their own.

All of these developments have created a hostile environment for the predominant number of MGAs that sprang up in the late 80's and the 90's.

The Flight to Quality

The MGAs who will succeed under current market conditions will have to transform themselves into MGUs. Expertise in the underwriting area and claims handling will have to be supported by sound technology and efficient operations.

In order to attract the appropriate risk-bearing partners to support the growing flight to quality demanded by agents and customers, an MGU must demonstrate its competence in a minimum of two areas and preferably three. Underwriting expertise and a solid information technology infrastructure will be entry-level requirements. A solid claims unit, or TPA, with specific expertise can significantly improve the attractiveness of an MGU operation.

Underwriting has always been the cornerstone of profitability for risk bearers. As standards lag, so do results, but having underwriting expertise alone is not enough. An effective MGU must have a grasp of the data, which underlies each of its programs. Competent analysis of policy level data in conjunction with loss data provides the road map to underwriting profitability. If a program administrator cannot demonstrate the ability to analyze its program data, then it can’t pass the MGU acid test. However, in order to analyze data, an MGU must have its data in an organized and manageable database.

During recent soft-market conditions, the validity of data in the market place was rarely questioned. In many cases, that data was suspect, if not false. This was especially true for smaller MGAs who did not have the technology to create a credible database. Under today's market conditions, suspect data draws an immediate declination. As such, it is not enough to have a bare bones policy delivery system for each program. MGUs must have the capability to integrate whatever policy delivery system is in use - be it their own or their carrier's - with a controlled data warehouse which will allow them to capture and manipulate both policy level and claims data.

While the lack of MGU in-house claims handling is not a deal breaker in today's market, having the ability to tie claims information to policy information is critical. This is not only true in the analytical arena, but also in the underwriting arena. If an MGU can give its underwriters access to its claims information on a real-time basis through technology, it has something to offer that many national primary carriers do not currently possess. Obviously, the better the expertise an MGU has in claims handling, the better its chances to produce an underwriting profit. This is especially true in long tail lines of business. If an organization can combine the expertise from underwriting and claims, then the potential for profit significantly increases.

Expertise and infrastructure notwithstanding, an efficient operating model is paramount in today's environment. Because most MGU programs are backed by reinsurance, either at the MGU level or the carrier level, less attractive terms at treaty renewal will flow directly to the MGU. While some of the commission reduction will be passed on to the retail producers, the MGU who can operate more efficiently may not be forced to lower retail commissions to the same extent, and will therefore be able to improve its posture in the marketplace.

Another critical skill set to further an MGU's efficiency and differentiation will be in its ability to electronically interface with its distribution partners. The development of an effective e-commerce web-site will not only reduce delivery expenses, it will provide an ease of doing business. To date, such effectiveness exists in very few property and casualty program environments. Nevertheless, building a state of the art e-commerce web-site is a foolish endeavor if the back room technology cannot support the resulting flow of business. A more streamlined and technology-based delivery system will also open the doors to additional risk-bearing partners who do not have policy delivery or claims payment systems.

Finally, finding creative ways to share risk with carriers and reinsurers will also be imperative. If an MGU is going to represent credibly that it can effectively underwrite and pay claims, then it will need to be prepared to put some skin in the game. This will require a strong balance sheet and some expertise at creating cost-effective risk sharing schemes. Many MGAs are putting their businesses at risk because they do not understand the risk-sharing schemes in which they are asked to participate nor have they effectively capped their liability.

Still Alive and Well

While the demise of the MGA may not be far from the mark, the opportunity for a well run MGU in today's market is significant. With the appropriate investment in expertise, technology, and a lean operating structure, the opportunity to stand apart as an MGU has never been better. With tightening market conditions, the use of MGUs as a delivery model could result in significant underwriting profits for primary carriers and reinsurers, *if they choose the right partner*. The basics are still the same. Program business offers one of the best avenues to generate an underwriting profit because of its homogeneity, ease of analysis, concentration of expertise in underwriting and claims, and its above average customer loyalty. The key is finding the right fit with the right organization.