# Types of Insurers

## Insurers' Corporate Structure

### Stock Insurers

**Stock insurers** are organized in the same way as other privately owned corporations created for the purpose of making a profit and maximizing the value of the organization for the benefit of the owners. Individuals provide the operating capital for the company. Stock companies can be publicly traded in the stock markets or privately held. Stockholders receive dividends when the company is profitable.

### Mutual Insurers

**Mutual insurers** are owned and controlled, in theory if not in practice, by their policyowners. They have no stockholders and issue no capital stock. People become owners by purchasing an insurance policy from the mutual insurer. Profits are shared with owners as **policyowners' dividends**. Company officers are appointed by a board of directors that is, at least theoretically, elected by policyowners. The stated purpose of the organization is to provide low-cost insurance rather than to make a profit for stockholders.

Research shows that mutual and stock insurers are highly competitive in the sense that neither seems to outperform the other. There are high-quality, low-cost insurers of both types. A wise consumer should analyze both before buying insurance.

Many mutual insurers in both the life/health and property/casualty fields are large and operate over large areas of the country. These large mutuals do a general business in the life/health and property/casualty insurance fields, rather than confining their efforts to a small geographic area or a particular type of insured. The largest property/casualty mutual insurer in the United States is State Farm, which was established in 1922 by George J. Mecherle, an Illinois farmer who turned to insurance sales. State Farm grew to be the leading auto and homeowner's insurer in the United States, with twenty-five regional offices, more than 79,000 employees, and nearly 70 million policies in force. Because of its mutual status, State Farm is overcapitalized (holding relatively more surplus than its peer group or stock companies).

## Demutualization

When top managers of a mutual company decide they need to raise capital, they may go through a process called demutualization. In the last decade, there was an increase in the number of companies that decided to demutualize and become stock companies. Policyholders, who were owners of the mutual company, received shares in the stock company. Part of the motive was to provide top management with an additional avenue of income in the form of stock options in the company. The demutualization wave in the life insurance industry reached its peak in December 2001, when the large mutual insurer, Prudential, converted to a stock company. The decade between the mid-1990s and mid-2000s saw the demutualization of twenty-two life insurance companies: Unum, Equitable Life, Guarantee Mutual, State Mutual (First American Financial Life), Farm Family, Mutual of New York, Standard Insurance, Manulife, Mutual Life of Canada (Clarica), Canada Life, Industrial Alliance, John Hancock, Metropolitan Life, Sun Life of Canada, Central Life Assurance (AmerUs), Indianapolis Life, Phoenix Home Life, Principal Mutual, Anthem Life, Provident Mutual, Prudential, and General American Mutual Holding Company (which was sold to MetLife through its liquidation by the Missouri Department of Insurance). [1]

## Lloyd's of London: A Global Insurance Exchange

**Lloyd's of London** is the oldest insurance organization in existence; it started in a coffeehouse in London in 1688. Lloyds conducts a worldwide business primarily from England, though it is also licensed in Illinois and Kentucky. It maintains a trust fund in the United States for the protection of insureds in this country. In states where Lloyd's is not licensed, it is considered a nonadmitted insurer. States primarily allow such nonadmitted insurers to sell only coverage that is unavailable from their licensed (admitted) insurers. This generally unavailable coverage is known as excess and surplus lines insurance, and it is Lloyd's primary U.S. business.

Lloyd's does not assume risks in the manner of other insurers. Instead, individual members of Lloyd's, called Names, accept insurance risks by providing capital to an underwriting syndicate. Each syndicate is made up of many Names and accepts risks through one or more brokers. Surplus lines agents—those who sell for excess and surplus lines insurers—direct business to brokers at one or more syndicates. Syndicates, rather than Names, make the underwriting decisions of which risks to accept. Various activities of Lloyd's are supervised by two governing committees—one for market management and another for regulation of financial matters. The syndicates are known to accept exotic risks and reinsure much of the asbestos and catastrophic risk in the United States. They also insure aviation.

The arrangement of Lloyd's of London is similar to that of an organized stock exchange in which physical facilities are owned by the exchange, but business is transacted by the members. The personal liability of individual Names has been unlimited; they have been legally liable for their underwriting losses under Lloyd's policies to the full extent of their personal and business assets. This point is sometimes emphasized by telling new male members that they are liable "down to their cufflinks" and for female members "down to their earrings." In addition to Names being required to make deposits of capital with the governing committee for financial matters, each Name is required to put premiums into a trust fund that makes them exclusively encumbered to the Name's underwriting liabilities until the obligations under the policies for which the premiums were paid have been fulfilled. Underwriting accounts are audited annually to ensure that assets and liabilities are correctly valued and that assets are sufficient to meet underwriting liabilities. Normally, profits are distributed annually. Following losses, Names may be asked to make additional contributions. A trust fund covers the losses of bankrupt Names. A supervisory committee has authority to suspend or expel members.

Seldom does one syndicate assume all of one large exposure; it assumes part. Thus, an individual Name typically becomes liable for a small fraction of 1 percent of the total liability assumed in one policy. Historically, syndicates also reinsured with each other to provide more risk sharing. The practice of sharing risk through reinsurance within the Lloyd's organization magnified the impact of heavy losses incurred by Lloyd's members for 1988 through 1992. Losses for these five years reached the unprecedented level of $14.2 billion. Reinsurance losses on U.S. business were a major contributor to losses due to asbestos and pollution, hurricanes Hugo and Andrew, the 1989 San Francisco earthquake, the Exxon *Valdez* oil spill, and other product liabilities.

The massive losses wiped out the fortunes of many Names. In 1953, Lloyd's consisted of 3,400 Names, most of whom were wealthy citizens of the British Commonwealth. By 1989, many less wealthy, upper-middle-class people had been enticed to become Names with unlimited liability, pushing the total number of Names to an all-time high of 34,000 in 400 syndicates. By mid-1994, only about 17,500 Names and 178 underwriting syndicates (with just ninety-six accepting new business) remained. As a result of the mammoth total losses (and bankruptcy or rehabilitation for many individual members), Lloyd's had reduced underwriting capacity and was experiencing difficulty in attracting new capital. What started in a coffeehouse was getting close to the inside of the percolator.

Among Lloyd's reforms was the acceptance of corporate capital. By mid-1994, 15 percent of its capital was from twenty-five corporations that, unlike individual Names, have their liability limited to the amount of invested capital. Another reform consisted of a new system of compulsory stop-loss insurance designed to help members reduce exposure to large losses. Reinsurance among syndicates has ceased.

Other forms of insurance entities that are used infrequently are not featured in this textbook.

## Banks and Insurance

For decades, savings banks in Massachusetts, New York, and Connecticut have sold life insurance in one of two ways: by establishing life insurance departments or by acting as agents for other savings banks with insurance departments. Savings banks sell the usual types of individual life insurance policies and annuities, as well as group life insurance. Business is transacted on an over-the-counter basis or by mail. No agents are employed to sell the insurance; however, advertising is used extensively for marketing. Insurance is provided at a relatively low cost.

Many savings and loan associations have been selling personal property/casualty insurance (and some life insurance) through nonbanking subsidiaries. Commercial banks have lobbied hard for permission to both underwrite (issue contracts and accept risks as an insurer) and sell all types of insurance. Approximately two-thirds of the states have granted state-chartered banks this permission. At this time, national banks have not been granted such power. [2]

In November 1999, State Farm Mutual Automobile Insurance Company opened State Farm Bank. At the time of this writing, State Farm has banking services in eleven states—Alabama, Arizona, Colorado, Illinois, Indiana, Mississippi, Missouri, New Mexico, Nevada, Utah, and Wyoming—and plans to expand to all fifty states. The banking division benefits from State Farm's 16,000 agents, who can market a full range of banking products. [3]

The U.S. Supreme Court approved (with a 9–0 vote) the sale of fixed-dollar and variable annuities by national banks, reasoning that annuities are investments rather than insurance. Banks are strong in annuities sales.

## Captives, Risk Retention Groups, and Alternative Markets

Risk retention groups and captives are forms of self-insurance. Broadly defined, a **captive insurance company** is a company that provides insurance coverage to its parent company and other affiliated organizations. The captive is controlled by its policyholder-parent. Some captives sell coverage to nonaffiliated organizations. Others are comprised of members of industry associations, resulting in captives that closely resemble the early mutual insurers.

Forming a captive insurer is an expensive undertaking. Capital must be contributed in order to develop a net worth sufficient to meet regulatory (and financial stability) requirements. Start-up costs for licensing, chartering, and managing the captive are also incurred. And, of course, the captive needs constant managing, requiring that effort be expended by the firm's risk management department and/or that a management company be hired.

To justify these costs, the parent company considers various factors. One is the availability of insurance in the commercial insurance market. During the liability insurance crisis of the 1980s, for example, pollution liability coverage became almost nonexistent. Chemical and other firms formed captives to fill the void. Today, there is a big push for captives after the losses of September 11. Another factor considered in deciding on a captive is the opportunity cost of money. If the parent can use funds more productively (that is, can earn a higher after-tax return on investment) than the insurer can, the formation of a captive may be wise. The risk manager must assess the importance of the insurer's claims adjusting and other services (including underwriting) when evaluating whether to create a captive. Insurers' services are very important considerations. One reason to create a captive is to have access to the reinsurance market for stop-loss catastrophic coverage for the captive. One currently popular use of captives is to coordinate the insurance programs of a firm's foreign operations. An added advantage of captives in this setting is the ability to manage exchange rate risks as well as the pure risks more common to traditional risk managers. Perhaps of primary significance is that captives give their parents access to the reinsurance market.

Captive managers in Bermuda received many inquiries after September 11, 2001, as U.S. insurance buyers searched for lower rates. The level of reinsurance capacity is always a concern for captive owners because reinsurers provide the catastrophic layer of protection. In the past, reinsurance was rather inexpensive for captives. [4]

A special form of self-insurance is known as a **risk retention group**.[5] An interesting example of the risk retention group in practice is the one formed recently by the airline industry, which suffered disproportional losses as a result of September 11, 2001. A risk retention group designed to cover passenger and third-party war risk liability for airlines gained regulatory approval in Vermont. [6] The risk retention group for airlines is named Equitime, and it was formed by the Air Transport Association (ATA), a Washington, D.C.-based trade group, and Marsh, Inc. (one of the largest brokerage firms worldwide). Equitime offers as much as $1.5 billion in combined limits for passenger and third-party war risk liability. Equitime's plan is to retain $300 million of the limit and reinsure the balance with the federal government. The capitalization of this risk retention group is through a private placement of stock from twenty-four airlines belonging to the ATA and about fifty members of the Regional Airline Association. [7]

Alternative markets are the markets of all self-insurance programs. Captives and group captives will see steady growth in membership. In addition, **governmental risk pools** have been formed for governmental entities to provide group self-insurance coverage such as the Texas Association of School Boards (TASB), municipals risk pools, and other taxing-authorities pools. TASB, for example, offers to the Texas school districts a pooling arrangement for workers' compensation and property, liability, and health insurance. Public risk pools have a large association, the Public Risk Management Association (PRIMA), which provides support and education to public risk pools. [8]

## Government Insuring Organizations

Federal and state government agencies account for nearly half of the insurance activity in the United States. Primarily, they fill a gap where private insurers have not provided coverage, in most cases, because the exposure does not adequately meet the ideal requisites for private insurance. However, some governmental programs (examples include the Maryland automobile fund, state workers' compensation, insurance plans, crop insurance, and a Wisconsin life plan) exist for political reasons. Government insurers created for political goals usually compete with private firms. This section briefly summarizes state and federal government insurance activities.

## State Insuring Organizations

- All states administer unemployment compensation insurance programs. All states also have guaranty funds that provide partial or complete coverage in cases of insurance company failure from all insurers in the market. This ensures that the results of insolvencies are not borne solely by certain policyowners. Covered lines of insurance and maximum liability per policyowner vary by state. Financing is provided on a postloss assessment basis (except for preloss assessments in New York) by involuntary contributions from all insurance companies licensed in the state. An insurer's contributions to a particular state are proportionate to its volume of business in the state. No benefits are paid to stockholders of defunct insurers. The funds are responsible for the obligations of insolvent companies owed to their policyowners.
- Eighteen states have funds to insure worker's compensation benefits. Some funds are monopolistic, while others compete with private insurers.
- Several states provide temporary nonoccupational disability insurance, title insurance, or medical malpractice insurance. Many states provide medical malpractice insurance (discussed in upcoming chapters) through joint underwriting associations (JUAs), which provide coverage to those who cannot obtain insurance in the regular markets. The JUAs are created by state legislation. If a JUA experiences losses in excess of its expectations, it has the power to assess all insurers that write liability insurance in the state. However, rates are supposed to be set at a level adequate to avoid such assessments. Some states have also created JUAs for lawyers and other groups that have had difficulty finding insurance in the private market.
- Seven states along the Atlantic and Gulf coasts assure the availability of property insurance, and indirect loss insurance in some states, to property owners of coastal areas exposed to hurricanes and other windstorms. Insurance is written through beach and windstorm insurance plans that provide coverage to those who cannot obtain insurance in the regular markets, especially in areas prone to natural catastrophes and hurricanes. Compliance with building codes is encouraged for loss reduction.
- The state of Maryland operates a fund to provide automobile liability insurance to Maryland motorists unable to buy it in the private market. The Wisconsin State Life Fund sells life insurance to residents of Wisconsin on an individual basis similar to that of private life insurers.

In recent years, several states have created health insurance pools to give uninsurable individuals access to health insurance. Coverage may be limited and expensive.

## Federal Insuring Organizations

- The Social Security Administration, which operates the Social Security program, collects more premiums (in the form of payroll taxes) and pays more claims than any other insurance organization in the United States. The Federal Deposit Insurance Corporation insures depositors against loss caused by the failure of a bank. Credit union accounts are protected by the National Credit Union Administration. The Securities Investor Protection Corporation covers securities held by investment brokers and dealers.
- The Federal Crop Insurance Corporation provides open-perils insurance for farm crops. Policies are sold and serviced by the private market. The federal government provides subsidies and reinsurance.
- The Federal Crime Insurance Program covers losses due to burglary and robbery in both personal and commercial markets.
- Fair Access to Insurance Requirements (FAIR) plans have been established in a number of states under federal legislation. They are operated by private insurers as a pool to make property insurance available to applicants who cannot buy it in the regular market. Federal government reinsurance pays for excessive losses caused by riots and civil disorder.
- The National Flood Insurance Program provides flood insurance through private agents in communities that have met federal requirements designed to reduce flood losses. (See Chapter 1 "The Nature of Risk: Losses and Opportunities" for a description of the federal flood insurance.)
- The Veterans Administration provides several programs for veterans. Several federal agencies insure mortgage loans made by private lenders against losses due to borrowers failing to make payments. The Pension Benefit Guaranty Corporation protects certain retirement plan benefits in the event the plan sponsor fails to fulfill its promises to participants. The Overseas Private Investment Corporation (OPIC) protects against losses suffered by U.S. citizens through political risks in underdeveloped countries.