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PROGRAM PARTNERSHIPS: MARKET DYNAMICS FOR MGAS AND PROGRAM ADMINISTRATORS

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INTRODUCTION:

The program market in the US is a vibrant, diversified niche in the insurance sector.

Growth is strong, and current economic and commercial developments create abundant new opportunities for risk transfer products.

However, at the same time, evolution (and sometimes revolution) in the competitive landscape pose serious threats to the program sector, demanding new approaches to remain relevant in today's market.

This Advisen paper, sponsored by Allied World, has three objectives:

- Outline the size and shape of the marketplace and highlight some of the opportunities for Program Administrators (PAs)
- Reinforce best practices for partnerships with insurance carriers
- Educate existing PAs on emerging threats to growth and opportunities to increase the value of the Program market in the US

WHAT IS A PROGRAM?

Program business means different things to different parties. Common to the various published definitions is the concept of grouping risks that share common characteristics. The insurance for this group is underwritten by a third party on behalf of an insurance carrier.

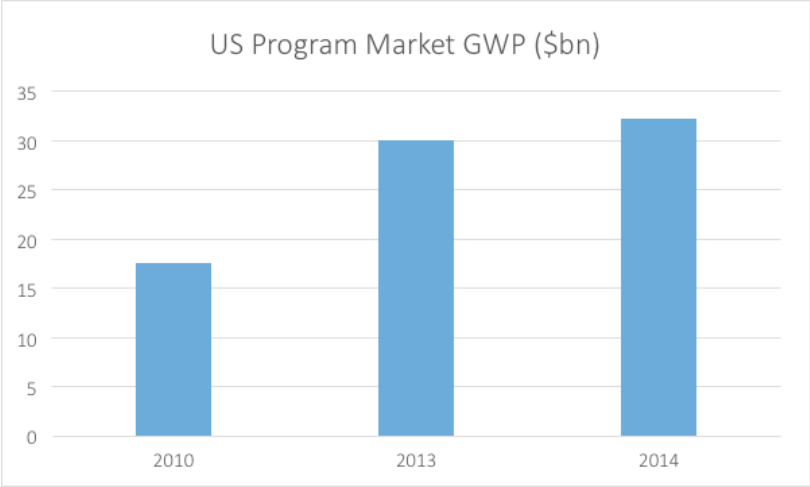
Allied World focuses on PAs that have an expertise in a specialty class of business. "We look to partner with PAs that give us a distinct advantage by having specific expertise and/or distribution relationships within the specialty class, allowing us to offer tailored coverage and service for our insureds," said Allied World's Senior Vice President of North America Programs, Grace Meek.

Those groupings of risks can fall within commercial or personal lines. For the purposes of this paper, we will concentrate on US commercial lines business only – more specifically specialty lines. We will refer to PAs, MGAs and MGUs as PAs, for ease of reference.

THE MARKET: SIZE AND SHAPE OF THE US PROGRAM MARKETPLACE

One of the most comprehensive sources of data on the program market is the Target Markets Program Administrators Association (TMPAA) bi-annual survey, soliciting data from its almost 400 members, which is understood to represent around 1/3rd of the US program market.

The 2015 report estimates that there are 1,000 PAs in the US marketplace, writing $32.3 billion gross written premium (GWP) in 2014. This is almost double the GWP written in 2010. The TMPAA estimates that its PA members are responsible for between $18-20 billion of this total.



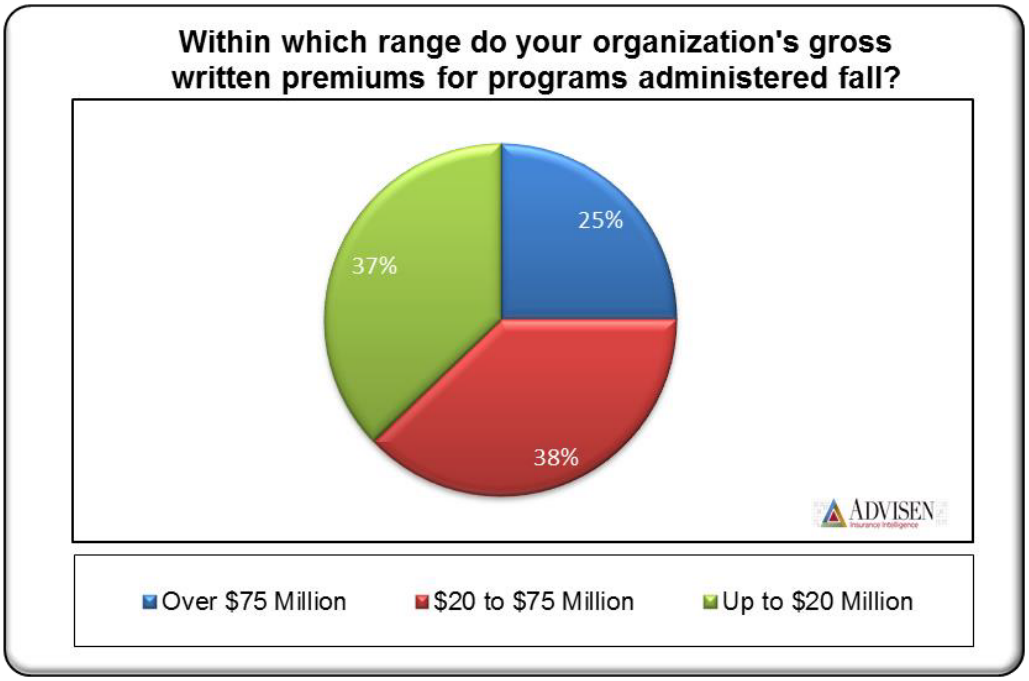
Source: TMPAA survey 2015

Some estimates – including a recent survey by reinsurance broker Guy Carpenter – put the market size as high as $40-50bn.

Although growth has slowed in recent years, it still outpaces that of the commercial lines insurance market. TMPAA shows program business rose by 7.3 percent in 2013-14, while direct premiums written for commercial lines increased by only 1.7 percent.

PROGRAM CHARACTERISTICS

The majority of PAs surveyed by the TMPAA write more than $20 million per year. The number of administrators who reported increases in premiums rose from 52 percent in 2010 to 82 percent in 2014.



Source: TMPAA survey

These portfolios are profitable, according to Guy Carpenter. In their recent survey, 73 percent of respondents said the combined ratio was less than 95 percent. None said it was over 100 percent.

The top three lines of business underwritten are liability, property, and excess/umbrella. The bottom three are financial and political risk, medical malpractice, and marine and aviation, according to the TMPAA.

It is not always the class of business that defines a program. Often, in the specialty sector, carriers offer commercial package programs for specific niche industries and associations. For example, Allied World offers a package including liability, auto, property and excess to specialty industries.

WHAT AUTHORITY DO PAS TYPICALLY HAVE?

Most carriers expect their PAs to:

- Underwrite
- Rate
- Quote
- Bind business
- Issue and service policies
- Provide marketing
- Provide technology services

The following services may be provided by the carrier, or outsourced to a third-party provider:

- Premium audits
- Loss control services
- Actuarial services
- Claims administration

Carriers will also conduct regular audits of claims, financial accounts and underwriting. Allied World, for example, will undertake a minimum of one underwriting audit per PA office, per year. Claims and financials will also be audited each year. If any issues come to light, the carrier may increase this frequency.

HOW DOES REMUNERATION WORK?

There are various ways that carriers can incentivize their PAs to bring in long-term, profitable business in their programs, including:

- Flat-rate fee
- Sliding scale (based on profitability): This method ensures an alignment of objectives between the carrier and PA to create an underwriting profit
- Profit share: According to the TMPAA survey, 63 percent of PAs share profit with their carrier partners. This works to reward PAs for the introduction of strong underwriting results to the portfolio and creates alignment of interests.
- Risk share: As with the sliding scale fees, there is alignment of interests here, but a lack of collateralization may result in an inability for carriers to recoup the downside of this arrangement. Only 27 percent of PAs surveyed by the TMPAA share risk with their carrier partners.
- California-based K2 Insurance shares an element of risk with carriers, by owning two admitted carriers. Bob Kimmel, K2's President, estimates that of its $300mn in revenue, K2 maintains almost 50 percent gross and 30 percent net on its own balance sheet.
- Other corporate structures, including captives: The administrative costs and risk associated with establishing captives can be high. Carriers may prefer a profit share.

CHARACTERISTICS OF A GOOD PA: THE CARRIER VIEW

LONG-TERM VIEW

Advisen asked Allied World's, Grace Meek, what characteristics she looked for in a good PA:

"At Allied World, we are interested in stability, predictability and long-term relationships, where solid underwriting results are key. It is expensive for carriers to start a program and the commitment for PAs is large. Therefore, partnering with PAs who know their business, have a strong track record and produce consistent underwriting results is crucial to building those long-term relationships."

It can take 18 months before a new program is fully operational, and Meek would not consider a partnership with a time horizon any less than three years.

In a recent webinar, hosted by A.M. Best and Target Markets, Anthony Campisi, President/CEO, Glatfelter Insurance Group, concurred. "Carriers will question the credibility of a PA to create a sustainable, profitable business that provides an acceptable window for return on the initial investment in the platform."

INDUSTRY SPECIALIZATION

In order to drive underwriting profit, California-based MGA firm K2 – which specializes in buying and starting new MGAs – insists that finding PAs who are experts in their chosen niche is crucial. "We don't write commodity business, MGAs can offer little value in commodity lines – the technological capabilities and predictive analytics of companies like Geico, Progressive or Allstate would kill us every time," Kimmel told Advisen.

"We always seek a niche within a sector," he added. "When we consider Workers' Compensation, for example, we write only truck drivers. In Personal Property, we mostly write manufactured housing."

Paul Fuller— President, Alteris Insurance Services — explained how he differentiated his Program Administration business from the competition.

Alteris focuses on niches within four industries across the US: Water, Emergency Services, Logging Contractors and foresters and Wineries.

"Alteris' 'secret sauce' is our segment excellence. We have to have unique expertise, control and access to sub-sets of our industries.

"We also go one step further – to truly become a part of the industry, by gaining industry credentials. For example, to support our Water program, I am a certified water operator in the state of California. In this way, we are considered as peers, not vendors, to our sectors."

STABILITY AND UNDERWRITING FOCUS

While specialization in an industry niche is important to differentiate your program in a competitive marketplace, basic risk-spreading discipline is also crucial, from a carrier perspective. Therefore, Allied World targets programs with annualized premium income of $10mn or more.

"Size is important to create balance in a portfolio and stability when losses come in. You need enough premium for the policy limits offered in order to cover losses in the long term," Grace Meek said.

STRONG DATA AND ANALYTICS

Carriers require reliable, robust data in order to help PAs make underwriting decisions, to monitor the success of programs and also to best address claims when they arise.

How do carriers get that data and what do they ask for?

Allied World's Grace Meek explains: "It is extremely important for carriers to get detailed, policy-level data from their PAs. Allied World does not require PAs to work within our systems to provide that information – we prefer our PAs to use their own systems and own their data. This ensures that they understand their business better and can make informed, autonomous decisions and act as a true underwriting entity."

Speaking on the recent A.M. Best webinar, Anthony Campisi said: "Control your data. Know it better than anyone else and you'll have a platform that's hard to imitate."

CHARACTERISTICS OF A GOOD PROGRAM CARRIER: THE PA VIEW

DUE DILIGENCE

A concern of PAs in today's market is gaining access to long-term capital providers that share a commitment to the program marketplace.

The program sector is attractive for carriers to seek top-line growth. The TMPAA survey showed that the majority of carriers polled plan to expand within the next three years. Their program strategy also includes plans to add programs over that period.

Allied World's Meek advises PAs to research potential capital providers before engaging: "Who does that carrier currently do business with? How long have they been partnering with their existing PAs? This will tell you a lot about the caliber of their programs and their commitment to this sector."

Meek also advises considering any conflicts that carriers might have with their channels of delivery for program products. Is the carrier seeking distribution channels for an existing product? Do they have competing direct portfolios or programs in your niche sector?

Alteris' Paul Fuller said: "Find a carrier with a strategy to build a sufficient amount of program business that is profitable, to ensure the longevity and health of your business. The value of a risk bearer is no longer just the capital they provide. It's reputation, risk appetite, reinsurance relationships and a commitment to the program space."

DEVELOPING NEW PROGRAMS: HOW TO GROW IN TODAY'S MARKET

There is a disconnect between the number of new programs seeking capacity and the availability of capital for start-up PAs, according to A.M. Best webinar panelist, Christopher Pesce — President, Maritime Program Group.

However, as noted above, an influx of new capital into the program sector may help close this gap. The Lloyd's market, for example, which wrote around $5bn of US program premium in 2015, is "open to start-ups", according to webinar panelist, Richard Hodge, Director International Specialty Division, at broker TYSERS.

Allied World will consider start-up programs, Grace Meek told Advisen, but its decision will be based on the underwriting characteristics, the expertise and track record of the PA.

Alteris, one of Allied World's PAs, takes a conservative view on growth – recently adding craft brewers to its winery portfolio. "Our growth is at a moderate pace, expanding our footprint by looking at adjacent areas," Fuller explained.

That said, it can take a long time to launch a new program in the market – anywhere from 10-18 months.

THE FUTURE: OPPORTUNITIES AND THREATS

The insurance landscape is changing rapidly, with an influx of new capital sources, low rating environments pushing carriers to seek top-line growth, M&A activity causing disruption and technology driving fundamental changes in the way business is conducted and how data is used in insurance.

All of these changes will affect the program market in different ways over the coming years – some of them fundamentally.

NEW CAPITAL

The appetite of new capital into the insurance sector is growing and investors are looking to aggressively take on insurance risk in other areas. This capital is un-encumbered by legacy infrastructure and can easily adopt new technology and distribution channels to reach the insurance customer.

A.M. Best webinar panelist, Romolo Braga, SVP at BMS Intermediaries, said alternative sources of capital are both the "greatest threat, and greatest opportunity" for the program market. "If you're not partnering with this new capital, they'll find a way to do it without you," Braga said.

K2's Bob Kimmel concurred that hedge fund capital is trying to get closer to the customer — operating in the primary market and even owning MGAs. K2 recently concluded a quota share reinsurance arrangement with a hedge fund.

TECHNOLOGY

The step-changes occurring in the technology sector are affecting the program market, and will continue to do so.

Maritime Program Group's Christopher Pesce, said the insurance industry is ripe to be "uberized" – with new entrants operating leaner, efficient, technology-led businesses compared to the program sector, where he estimated that around 47 cents on each premium dollar is spent on business overheads, not claims.

Carriers are also using technology to challenge the PA sector. More efficient placement tools are giving carriers more online access to customers and an easier way to collect small premiums.

It is worth noting, however, that certain lines of business are more susceptible to disruption from technology than others. It is more difficult to automate the underwriting process for more complex specialty lines, than it is for standardized commodity lines of business.

MERGERS & ACQUISITIONS

M&A in the program sector is vibrant; market research by Advisen suggests that around 150 PAs have been the subject of a sale in the past five years.

Often, the only exit strategy for owner-managed PA firms is to sell. With carriers looking for top-line growth in a soft insurance market, buying a PA is an easy way to grow.

K2 Insurance has purchased seven PAs since 2011, but estimates that around 75 of its original 100 target agencies have been sold in the period.

“Multiples are high for the name-brand MGAs and most of them have been sold now,” Kimmel said. “We seek out underwriting talent in our acquisitions. K2 doesn’t buy mature companies unless we can see revenue growth of around 200-300 percent. We seek regional companies which we can expand to a national footprint. Most of our targets will have been in business for more than 10 years, have a principal seeking a succession plan and where an IT investment can add great value.”

The program market, although significant, has a relatively small pool of talent available. One of the challenges for the sector in the coming years is to find new talent to replace the aging PA workforce.

One way that carriers and PAs are doing this is by creating training programs for younger employees. Allied World recently completed a 12-month training program for college graduates to fill this gap.

“Programs are a small subset of the insurance industry and it is often hard to find underwriting talent that understands the nuances of Program management. So to prepare for our future, we have invested time in a 12-month training program, exposing new underwriters to all aspects of managing a Program and insurance company operations,” Grace Meek said.

In conclusion, the US program marketplace is vibrant, and growing at a faster pace than the commercial insurance sector. New capital, technologies and emerging risks are all creating huge opportunities for the program sector to continue to provide specialized, profitable, underwriting solutions to customers’ exposures.

These opportunities, however, have to be managed conservatively, focusing on finding appropriate partners that share values and strive to offer long-term solutions to customers at a suitable price.