

Middlesex Mutual Assurance Company

Middlesex Mutual Assurance Company (MMA) was a small 150-year-old property casualty insurer that did 95 percent of its business in Connecticut. It sold insurance strictly through the independent agency system. About 25 percent of the agents in Connecticut represented MMA. MMA's forte was homeowners' insurance; it was the market leader in this line of insurance with approximately 10 percent of the market.

The key success factor for MMA had been excellent rapport with its independent agency force: agents enjoyed personalized service from company personnel who knew the Connecticut market quite well. MMA's main weakness was that it essentially offered only homeowners' insurance; it did not participate in any life or health insurance. However, these markets were of crucial importance to independent agents.

Recently, the coverage line for homeowners' insurance had been aggressively sought after by other insurance companies, and MMA was not confident that it could maintain market leadership in this line. Competition was becoming intense from sectors within and outside the independent agency system.

In the fall of 1990, Mr. Roger Smith, executive vice president of marketing at MMA, wondered what changes (if any) MMA could make in its distribution system to help ensure continued market leadership in the homeowners' insurance line.

INDUSTRY BACKGROUND

Financial

Property casualty insurance has characteristically been a good, healthy business to be in. Premium growth has been improving steadily since the 1950s, as shown in **Exhibit 1**.

The industry has been very profitable for most participants, particularly during the 1983–1987 period. The average ROE for the property casualty insurance industry during this period was 18.5 percent versus 14 percent for Standard and Poor's Top 500. The tremendous profitability in the industry for this time period can be explained as follows. Operations for 1980 and 1981 produced an underwriting loss; that is, companies paid out more in claims and operating expenses than they received in premium dollars. Because of this underwriting loss, companies sought and received large rate increases, which greatly increased premium income. At about the same time, interest rates on investable funds rose dramatically as a result of the general economic conditions that prevailed at the time. Thus, insurers not only received a large increase in premiums but were able to earn very attractive rates of return on the premiums they collected. Insurers could earn investment dollars on premiums until the premiums were actually paid out in claims. Often, claims were not paid until many years after premiums had been paid. This was particularly true in commercial lines where claims were not realized for many years (consider product liability where faulty parts cause an airplane to crash five years after they have been installed).

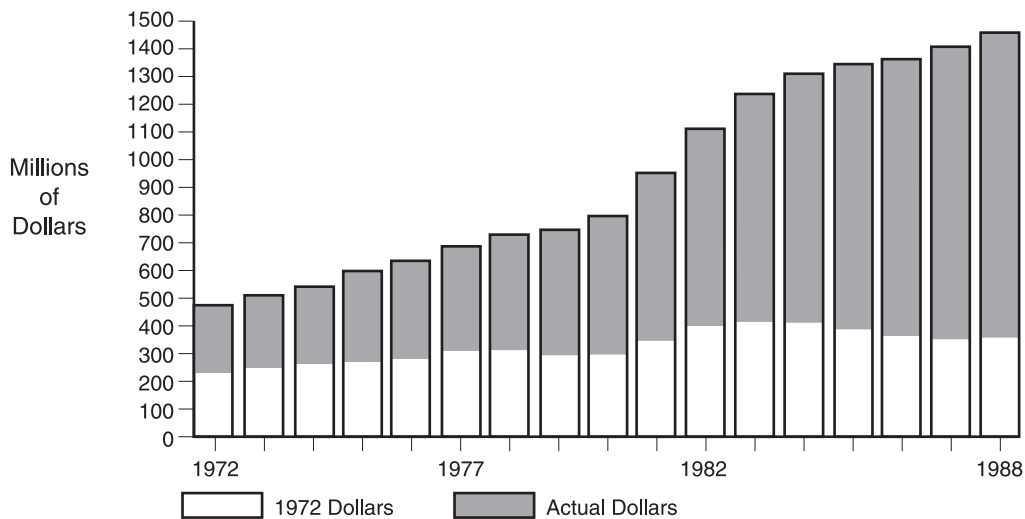
Naturally, the increase in premium levels and windfall investment income greatly increased insurers' profits. Increased profits led to increased capacity in the industry for two reasons:

1. Insurers, who were making high profits, wanted to provide more insurance coverage.
2. High profits attracted new entrants into the business.

Adequate insuring capacity to support society's needs was surpassed by an overcapacity, a "glut," in effect, of available insurance, as shown in **Exhibit 2**.

This case was prepared as a basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

EXHIBIT 1
Middlesex Mutual Assurance Company
Property Casualty Insurance Premium Growth, 1972 to 1988



Source: Best's Aggregates and Averages.

At first, companies could sustain an underwriting loss but still make a profit because of investment income on premium dollars. However, price cutting continued to a point where investment income could no longer offset huge underwriting losses, and companies began to lose money. Worse, interest rates began to decline rapidly with the improving overall economy. By early 1990, many insurers were on the verge of becoming financially insolvent. In order to remain solvent, many insurers began to raise premium rates; others were forced to cancel many policies or provide more restrictive coverage.

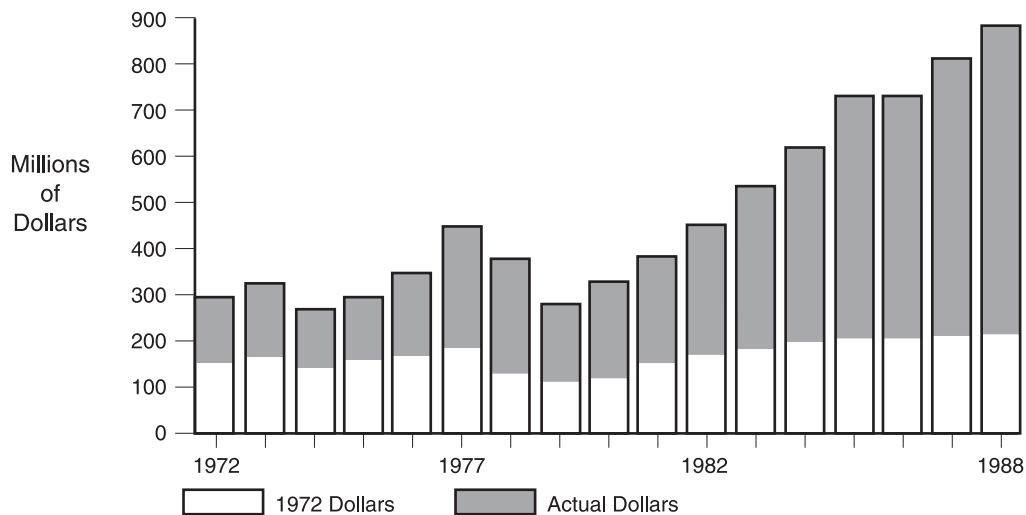
In general, the commercial lines market was most subject to the volatility described above—risks in commercial lines generated larger premiums and more investment income. Personal lines pricing, profitability, and availability were much more stable during this time.

Distribution

The insurance industry employed two basic means of distribution: independent agents and direct writers. Independent agency companies essentially acted as wholesalers—their insurance was marketed by agents who represented their companies as well as competitors. Direct writers, on the other hand, employed their own sales forces, or marketed their products through print or television media. (Note: Insurance for very large corporations is typically supplied by brokers who operate in much the same way as independent agents except that, unlike an agent, a broker represents the client rather than the insurer.)

Agency companies have been in business since before the turn of the century, whereas most direct writers gained prominence after World War II. In their traditional roles, agents, who were thought of

EXHIBIT 2
Middlesex Mutual Assurance Company
Growth in Policyholders' Surplus, 1972 to 1988



Source: Best's Aggregates and Averages.

as professionals similar to lawyers or accountants, would tailor programs of insurance to the needs of their clients. Direct writers approached insurance as more of a commodity; personal service was sacrificed for low price. Direct writing lent itself well to the personal lines business (i.e., auto and homeowners' insurance) because personal lines coverages are less complex and the personal lines customer generally does not require the degree of service that a commercial customer requires. During the past 20 years, agents tended toward commercial lines business—an area they continued to dominate. Direct writers had advanced dramatically in the personal lines. To illustrate the point, **Exhibit 3** shows the direct writers' share in the homeowners' business.

Direct writers did not generally fare well in commercial lines. Their market shares remained low, and they were much less profitable in this area than agency companies. Most of their growth in commercial lines came from very small, unsophisti-

cated accounts. However, the traditional roles of the direct writer and agency company had been somewhat changed, mainly for these reasons:

1. Agency companies were placing less emphasis on commercial lines. The chief factor was the terrible financial results they recently experienced in commercial lines. Their managements were under pressure to improve operating results, and emphasis on personal lines was the easiest way to accomplish the same. Further, as shown in **Exhibit 4**, the commercial lines market available to the independent agent was shrinking. On the other hand, the personal lines represented an area of potential growth.
2. Direct writers had come a long way in improving their level of service to the client. Direct writers had invested a great deal of time and effort in streamlining their operations. In some cases, direct writers provided service equal to or better than the level provided by agency companies.
3. Direct writers had begun to pursue commercial lines, especially small businesses. Many small business owners viewed insurance as a commodity; indeed,

EXHIBIT 3
Middlesex Mutual Assurance Company
Market Share Trends in Homeowners' Insurance

| Year | Market Share | |
|------|--------------|--------|
| | Agency | Direct |
| 1972 | 72% | 28% |
| 1978 | 59% | 41% |
| 1982 | 54% | 46% |
| 1983 | 53% | 47% |
| 1985 | 50% | 50% |

Source: Best Executive Data Service.

there was little coverage difference in small business insurance, and the required service level was similar to personal lines (i.e., relatively low). Further, the small business was becoming highly important to the U.S. economy: over 600,000 new businesses were started each year. According to Naisbitt, author of *Megatrends*, the United States would be in an "entrepreneurial explosion" to the end of this decade. The implication was that there will be no shortage of small commercial lines prospects for some time to come. In order to preserve their dominance in the commercial lines, agency companies would need to become adept at handling small businesses that required commodity-oriented insurance.

It was generally conceded that the direct writers enjoyed a 10 percent distribution cost advantage

over the agency companies. This advantage was due to the fact that the direct writers, owing to lack of a "middleman," were able to save on business distribution costs because their business systems were more streamlined. Further, they enjoyed a more efficient allocation of tasks: the producer spent time selling, while the company's wholesale function was to support the salesperson. With agency companies, the agent performed a great many activities (other than selling) that could be performed more efficiently at the company level, albeit at a less personalized level (e.g., claims handling, billing, etc.).

The agency companies realized that they would have a tough task invading the personal lines market and protecting their dominance in the small business commercial lines market. Significant portions of each of these markets demonstrated the belief that insurance is a commodity. Of necessity, the winner in a commodity market is the contestant who can offer the lowest price and still make a profit, and the direct writers generally had a 10 percent cost advantage with which to work.

Agency companies were observed taking the following actions in the personal lines and small business commercial lines markets:

1. Agency companies had halted the rapid advance of the direct writers by pricing under costs. Such action could not be sustained indefinitely.

EXHIBIT 4
Middlesex Mutual Assurance Company
Market Shares by Distribution Channel in the Commercial Lines Market

| Year | Market Share | | | | |
|-------|----------------|---------|---------|--------------------|----------------|
| | Risk Retention | Captive | Brokers | Independent Agents | Direct Writers |
| 1980 | 10.2% | 2.3% | 26.4% | 44.5% | 16.6% |
| 1982 | 12.1% | 4.6% | 21.9% | 45.0% | 16.4% |
| 1985 | 13.9% | 7.2% | 23.0% | 40.2% | 15.7% |
| 1995* | 15.0% | 11.0% | 24.0% | 35.0% | 15.0% |

Source: Best Executive Data Service.

*Data for 1995 are projections.

2. Efforts were made to improve efficiency of independent agency distribution channel by:
 - a. **Increasing emphasis on automation.** Many companies pursued electronic interface with their agencies; however, agents represent several companies, and they must interface with each one separately, which drastically decreases efficiency and increases agents' expenses. Lately, consulting firms have emerged, whose purpose is to standardize company/agency interface so that an agency can interface with all the companies it represents. This would substantially lower costs and enable companies to more effectively compete with direct writers. However, at the time of writing this case, the standardized system had not enjoyed widespread use.
 - b. **Experimenting with alternative distribution systems.** Hartford Insurance Group began marketing auto insurance directly to the consumer; they directly solicited consumers who were members of the American Association of Retired Persons. Other companies actively pursued relationships or joint ventures with banks.
 - c. **Beginning to pay agents lower commissions.** In return for accepting lower commissions, agents would need to perform fewer administrative and service tasks. The company would largely assume these tasks. Agents would spend more time selling rather than servicing.
 - d. **Dealing with fewer agents.** Economies of scale could be realized if companies could deal with fewer agencies, with each agency producing higher amounts of premium.
 - e. **Introducing product innovations.** Several insurers developed combination auto-homeowners' policies with broadened coverage. The slightly broadened coverage altered the commodity nature of the product. Further, an account with both auto and homeowners in one policy was less expensive to sell and service. Direct writers had yet to mimic this product. Other innovations included premium payment by credit cards.
 - f. **Using sophisticated marketing techniques.** Agency companies woke up and realized that consumers would not beat a path to their door to buy insurance. Companies started to mimic and improve some of the direct writers' effective promotion and pricing strategies.

As if the threat from existing direct writers wasn't enough, a significant threat was posed from new entrants, chiefly banks. Banks have intimate contact with all homeowners and automobile owners, not only because most people have checking and savings accounts, but because people utilize the bank for auto and homeowner mortgages and loans. Attitude surveys have shown that the average consumer places more credibility in a banker's advice than in an insurance agent's advice. Banks would possess an enormous competitive advantage because they see a large audience of insurance prospects on a daily basis. Further, as **Exhibit 5** shows, the public as a whole would be predisposed to buy insurance from a banker if the purchase of insurance would enhance the likelihood of obtaining a loan.

Further trends affecting the industry were (a) the public's perception that it understood more about insurance than previously and (b) the increased level of information available to consumers.

According to the *Public Attitude Monitor*, people are more aware of what insurance is and does. (See **Exhibit 6**.) More-informed people might rely less on the advice of an agent and be attracted to commodity-like pricing.

In regard to level of information, the day is not far off when people will have access to insurance pricing over personal computers at home.

To the extent that people are familiar with insurance and view it as a commodity, pricing will play a more important role in determining where insurance is purchased.

MMA PERSPECTIVES

MMA had been extremely profitable, although industry performance as a whole had deteriorated markedly during the last few years. The homeowners' insurance business (MMA's forte) had been much more stable than commercial lines. Further, MMA had been operating in an unusually favorable competitive environment for these reasons:

1. Direct writers were not as strong in Connecticut (the main geographic area in which MMA operated) as they were on a countrywide basis. (See **Exhibit 7**.)

EXHIBIT 5

*Middlesex Mutual Assurance Company**Public Perceptions Regarding Relationships between Financial Transactions by Banks and Insurance Companies*

| <i>Situation</i> | All Respondents | | | | | | |
|--|-----------------------|--------------|-----------------------|--------------------------|-----------------|--------------------------|------------------|
| | <i>Strongly Agree</i> | <i>Agree</i> | <i>Probably Agree</i> | <i>Probably Disagree</i> | <i>Disagree</i> | <i>Strongly Disagree</i> | <i>No Answer</i> |
| If banks sold auto insurance, people would be expected to buy auto insurance there in order to get an auto loan. | 6% | 25% | 24% | 14% | 23% | 6% | 1% |
| If auto insurance companies owned banks, people would be expected to finance cars there in order to get or keep auto insurance coverage. | 5 | 28 | 26 | 15 | 20 | 5 | 1 |
| If banks sold home insurance, people would be expected to buy homeowners' insurance there in order to get a mortgage loan. | 5 | 26 | 27 | 16 | 20 | 5 | 1 |
| If home insurance companies offered mortgage loans, people would be expected to get mortgages there in order to get homeowners' insurance. | 5 | 24 | 29 | 16 | 20 | 5 | 1 |

Number = 1.516

Source: Public Attitude Monitor, December, 1989.

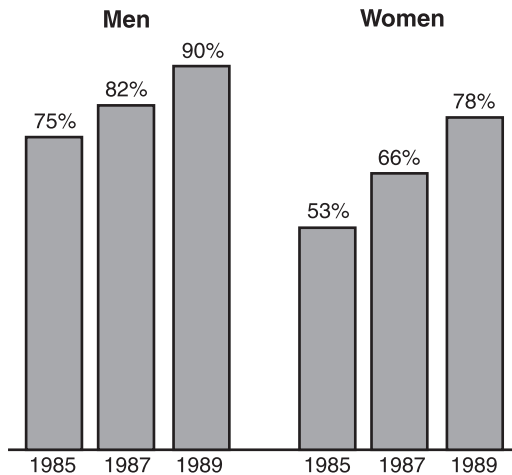
- Clearly, MMA's homeowners' insurance business had yet to be subjected to the degree of direct writer erosion exhibited in other areas of the country.
2. Despite the agency companies' dominance in the Connecticut personal lines market, most of their marketing thrust was directed toward commercial lines. Agency companies were not particularly aggressive in personal lines; they had really been asleep in regard to personal lines and were merely resting on their laurels.

Due to the relative weakness of direct writers in Connecticut and apathy on the part of agency companies, MMA had thrived and become the market leader in the homeowners' insurance business, with a 10 percent market share. However, the favorable competitive environment enjoyed by MMA could deteriorate for the following reasons:

1. **Increased competition**—In addition to the growing threat posed by direct writers and new entrants, agency companies could begin to emphasize personal lines coverage instead of commercial lines coverages. Agency companies were awakened from their slumber and were using sophisticated and aggressive marketing techniques to obtain homeowners' insurance. Profitability in the homeowners' insurance line was expected to deteriorate rapidly as competition intensified.

Of special concern to MMA was the degree of leverage that the large agency companies had over MMA agents (keep in mind that agents are independent and represent several companies). Large companies usually offer a full line of insurance services to their agents: personal lines (including personal auto), commercial lines, life and health insurance, and financial planning services. In order for independent

EXHIBIT 6
Middlesex Mutual Assurance Company
Percentage of Men and Women Saying They Consider
Themselves Well Informed about Auto Insurance



Source: *Public Attitude Monitor*, March 1990.

agents to survive, they needed to have all of these services available to their clients. Large agency companies realized how important they were to agents, and they also realized that their agents were giving much homeowners' insurance business to MMA. Homeowners' insurance was now recognized as a profitable line, and companies became upset when agents were placing homeowners' insurance with MMA, only to place the less desirable lines of business with them. Many companies offered MMA agents lucrative deals for books of MMA homeowners' insurance business. Others threatened to terminate their relationship with MMA agents unless the companies targeted their agents who were also MMA agents with promotional policyholders (many of whom presumably had homeowners' insurance with MMA) indicating they would receive a 10 percent discount on both the auto and homeowners' policies if they would place both coverages with their company.

The "strong-arm tactics" referred to above were usually resisted by independent agents because they wished to retain their independence as to the company where they placed their clients. True to their

name, most agents were highly independent in nature, and did not take kindly to insurance companies dictating business practice to them. However, agents were under a great deal of competitive pressure, and many had no choice but to submit to the demands of large full-service companies.

2. **Consumer trends**—There was increasing evidence that personal lines coverages were becoming viewed as more and more of a commodity, especially among the middle and lower socioeconomic classes. These people could be expected to seek out the lowest available price. As mentioned earlier, those persons wanting low price would be aided in the future by increasing access to information, probably by way of computer terminals.
3. **Distribution**—MMA did business exclusively through independent agents. The viability of the agency system, especially in personal lines, was being severely challenged by direct writers and new entrants. As previously mentioned, many companies weren't tying themselves directly to the fate of the independent agency system; many were beginning to develop alternative distribution mechanisms.

MMA corporate culture strongly opposed any experimentation with an alternative distribution system. The reasoning was simple. MMA was not a full-service company; it essentially offered only homeowners' insurance. MMA was viewed by agents as a nice company to represent but most often wasn't perceived as a bread-and-butter company. Other companies would be very happy to write an agent's homeowners' insurance book of business, albeit at a slightly lower service level. Because MMA was not an essential company to represent, agents could cease doing business with MMA without jeopardizing the viability of their own operations. Further, one of MMA's key success factors was its excellent rapport with agents. To damage this rapport was viewed as a serious mistake.

As previously mentioned, larger companies were actively reducing the number of agents through which they wrote business and were demanding that their remaining agents place higher amounts of premium with them. MMA executives believed that large companies, with their large overheads, could not economically service the small agent. MMA, on

EXHIBIT 7*Middlesex Mutual Assurance Company**Competitive Position of Agency Companies versus Direct Writers*

| Personal Auto Insurance | | |
|-------------------------|---------------------------|-------------------------|
| | 1988 U.S. Market Share | 1988 CT Market Share |
| Agency companies | 38.2% | 58.0% |
| Direct writers | 61.8% | 42.0% |
| Homeowners' Insurance | | |
| Agency companies | 53.7% | 74.3% |
| Direct writers | 46.3% | 25.7% |

Source: A.M. Best Company, A7 reports, 1989.

the other hand, had a strong local presence in Connecticut and could economically service smaller agents that larger companies could not. Industry data indicated that there were plenty of small agents in existence, with new agencies being created every day. These small agencies may not generate enough premium to quench the appetite of large companies, but MMA believed that enough small agents would survive and prosper to warrant consideration as a viable target market for MMA.

In short, Mr. Smith realized that the distribution of homeowners' insurance could change rapidly, and this was of great concern to him. After much deliberation, he felt that MMA should consider the following alternative courses of action:

1. Do nothing; just continue to sell homeowners' insurance through independent agents.
2. Continue selling just homeowners' insurance through agents but streamline the distribution system by using automation and more efficient allocation of tasks between company and agency.

3. Become a more important market to the agents by adding automobile insurance coverage. Otherwise, business as usual.
4. Become a more important market to the agent by adding automobile insurance, while adding the efficiency measures mentioned in Step 2.
5. Develop direct writing capabilities that would bypass the agent.

Mr. Smith decided on the following criteria to evaluate potential alternative actions:

1. Action must be of benefit to independent agents; agent alienation must be avoided.
2. Action must be within reasonable current capabilities of MMA.
3. Action must ensure short-term growth and viability of MMA in the homeowners' insurance market.
4. Action must ensure long-term growth and viability of MMA in the homeowners' insurance market.

The alternative courses of action and the criteria by which they were evaluated are summarized in a decision matrix in **Exhibit 8**.

EXHIBIT 8

Middlesex Mutual Assurance Company—Evaluation of Alternative Actions

| <i>Alternatives</i> | <i>Criteria</i> | | | | <i>Total</i> |
|--|---|---|---|--|--------------------------|
| | Action must benefit independent agents; alienation must be minimized or avoided | Action must complement and be compatible with MMA internal operations | Action must ensure short-term growth and viability of MMA homeowners' insurance product | Action must ensure long-term growth and viability of MMA homeowners' insurance product | |
| 1. Do nothing; continue to sell just homeowners' insurance coverage through independent agents. | 3 | 2 | 2 | 0 | 7 |
| 2. Continue selling homeowners' insurance coverage through independent agents but streamline distribution process by use of automation and more efficient allocation of tasks between agent and company. | 2 | 2 | 3 | 2 | 9 |
| 3. Become a more important market to the agent by offering personal auto insurance; otherwise, business as usual. | 4 | 3 | 3 | 2 | 12 |
| 4. Become a more important market to the agent by offering personal auto insurance; also increase efficiency by taking actions outlined in alternative (2). | 4 | 3 | 3 | 4 | 14 |
| 5. Develop direct writing capabilities that bypass the agent. | 0 | 2 | 0 | 3 | 5 |
| <i>Values</i> | 0—Very negative effect | 1—Somewhat negative effect | 2—Neutral effect | 3—Somewhat beneficial effect | 4—Very beneficial effect |

Source: Company records.

MMA executives selected alternative 4; it had the highest score of 14.