Dispelling the Myths about MGAs

Background

The Florida Property & Casualty Association ("FPCA") has put together this short fact sheet due to the recent press coverage regarding insurers using Managing General Agents ("MGAs"). FPCA members believe that there are many misconceptions and half-truths circulating about how MGAs operate and, as a result, the Legislature is considering legislation that will drive capital away from Florida and devastate the Florida insurance marketplace. Specifically, a proposal is being considered in the Legislature that would expand the regulation of MGAs and other insurer affiliates. Legislation like this will create such an onerous regulatory environment that new capital will cease to enter the Florida insurance market.

What is an MGA?

A Managing General Agent performs most, if not all, of the tasks normally considered administrative and sales functions of an insurance company. Typically these tasks include, but are not limited to, contracting with independent agents for marketing and acquiring business, negotiating commissions, underwriting, underwriting inspections, determining the basis of rates to be charged, issuing policies, processing endorsements, collecting premiums, administering claims, and most other policy administrative functions. For most Florida homeowner insurance companies, the MGA also solicits and negotiates critical external reinsurance arrangements. Some MGAs manage business for a number of companies, creating economies of scale through their volume and expertise. In other cases, the MGA may be a subsidiary of the same holding company that owns the insurance company.

There are some financial advantages to investors for utilizing an MGA structure. MGAs are typically organized as LLCs, which are not subject to corporate income tax at either the federal or state level. In contrast, investors of insurance companies are taxed twice – once at the insurer level and again at the owner level. Further, under existing standards imposed by the Office of Insurance Regulation ("OIR"), a new insurance company is not allowed to pay dividends to investors for its first three years regardless of profitability. When investors evaluate the very risky proposition of investing capital in the Florida residential property insurance market, they consider the time frame for a potential return on their investment. Legislation that would provide additional unpredictability through onerous regulation of MGAs and insurer affiliates will deter investors from investing in the Florida market, and in cases of catastrophes, deter investors from recapitalizing an existing company. This will result in a reduction of private market capacity in Florida. It is important to note that the insurance company remains the ultimate risk-bearing entity, however, so costs and losses impact the

insurance company's bottom line. This is why loss cost-drivers such as fraud, reopened and supplemental claims, inflated mitigation discounts, and increased reinsurance costs affect the insurance company rather than the MGA.

Myth v. Fact

Myth: All monies paid to an MGA are profit

Fact: An MGA fee does not equal an MGA profit. MGAs have significant expenses associated with performing the operational functions enumerated above, such as paying agent commissions, providing customer service, processing the business, handling claims and the like. The insurance company is required to incur these expenses, regardless of whether it does so directly or through an MGA. Most insurance companies pay an MGA fee to accomplish these functions and in most arrangements the MGA margin is what is left over after all the services are performed. Hence, it is in the MGA's interest to be as efficient as possible, and MGA's are motivated to ensure that the insurer is profitable in the long run as the insurer is the source of the MGA's income.

Myth: Investors will continue to support Florida homeowners insurance carriers despite high risk and even more uncertain returns.

Fact: Controlling and limiting the right to earn a reasonable profit by the MGA would add an additional level of uncertainty in an already uncertain market. It is axiomatic that you have to match reward to risk. It is obvious that Florida is a high risk homeowners insurance state with a large portion of the market in the nation's largest "residual" facility, many carriers fleeing, and the greatest hurricane exposure on the globe. Adding more uncertainty will result in further deterioration of the market, rather than improvement, and is likely to decrease availability of private insurance, competition, and consumer choice.

Myth: Overhead and/or expenses are higher in Florida because of MGAs.

Fact: Measuring overhead based on a dollar figure alone gives a distorted view. Insurance premiums are higher in Florida than the national average due to the overall higher degree of underwriting risk, underwriting requirements and other administrative costs. Therefore, a more appropriate comparison to other states would be the percentage of premium that overhead encompasses. According to the Insurance Information Institute (III), the typical expense ratio across the country is $30 dollars of $100 paid in premium, or 30%, with the remaining $70 paid for losses and other costs such as reinsurance, etc. Of the $30, the largest single component is usually producing agent commissions of $10 to $15, with the remaining used to pay for the administrative functions. In Florida, the expense ratio is consistent with the national average and is consistent with non-MGA companies.

Myth: OIR does not have the ability to review or control MGA fees or contracts.
Fact: OIR reviews each and every affiliate MGA contract and fees and approves them before the company is authorized to write business in Florida. In addition, the contracts are reviewed in conjunction with rate filings. Further, they are subject to review by OIR when it performs an examination of the insurer. OIR has the ability to refuse to approve MGA fees that they deem unreasonable, and take action if OIR believes abuses are occurring.

Tell me more about why insurance companies are losing money:

In short, insurers are losing money because they are not collecting enough premium to pay for their reinsurance and everyday non-hurricane losses. Many companies have lost money in Florida despite the absence of storms in the past few years. Interestingly, the largest losses have been from companies that do not use MGAs, which indicates that utilizing an MGA is not the cause of the loss. In other words, the legislative proposals circulating that relate to MGA regulation are not focusing on the loss cost drivers that have dramatically increased in recent years, but rather the administrative costs that have mostly remained static.

So, why are the companies losing money? Here are a few of the reasons:

1. Rates have been suppressed and have, in fact, declined in the last 3 years by as much as 25%.
2. Windstorm mitigation credits are overinflated and have added to underwriting costs.
3. Due to a variety of factors, including increased activity by public insurance adjusters, loss frequency is increasing at a furious pace and loss severity is very high as a result of statutes that allow claimants to reopen claims for 5 years after the event and settlements that must be based on replacement cost only, even if the insured has no intention of repairing the property.
4. Sinkhole coverage, as a result of misguided law, has become settlement coverage rather than catastrophic collapse coverage.

Focusing on MGAs as a solution to company solvency is misdirected. In fact, MGAs have increased the capacity in the state by attracting outside investment capital at a time when the non-MGA companies have abandoned the state. Additionally, regulation of MGA fees or a permanent reduction in MGA fees could cause defaults on loan agreements and be an unconstitutional impairment and interference with existing contracts. Further, this will give foreign companies a competitive advantage over Florida domestic companies. This legislation would penalize the Florida companies that have stabilized Florida's market.

So what should the Legislature do?

Because of the complicated nature of this issue the Legislature should call for a study of the issues surrounding why companies are losing money and whether MGAs are part of the problem or part of the solution. The following considerations also should be taken into account in any study:

1. Industry expense ratios in non-MGA companies.
2. Repercussions of additional severe restrictions on MGAs such as withdrawal of investor capital and elimination of future investment flow.
3. True impact of fraud, replacement cost in non-catastrophic periods, public adjusters, and artificial rate suppression.
4. The results of studies already conducted, such as the wind mitigation study the Legislature previously commissioned.

Other Alternatives:

The Legislature could authorize OIR to act or intervene when an insurance company's risk-based capital (RBC) score falls below 200, by allowing OIR to require:

1. A reduction of business without the required statutory notice; or
2. A reduction of expenses by renegotiating contracts with employees, MGAs, agents, third party administrators (TPAs), or other service providers; or
3. An increase in revenue by an expedited rate filing and rate implementation (without the required statutory notice to policyholders); or
4. The contribution of additional capital through the sale of stock or the issuance of a surplus note.

The RBC is an objective standard. The RBC rules apply to every insurance company, foreign and domestic alike. This approach focuses OIR's ability to intervene in companies that have a problem and that are a potential danger to the public. This approach would allow flexibility and wouldn't single out affiliated MGAs. More importantly, it would focus on the critical issue, which is insurer solvency.

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