



“Independent and Exclusive Agency Insurers: A Reexamination of the Cost Differential”

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The Journal of Risk and Insurance, 1992, Vol. 59, No. 3, 375-397

Synopsis by Colin Reinhart

As the insurance industry has matured, its distribution system has become more complex. Rather than entering untapped markets on their own, insurance companies had independent agents sell their products on their behalf; this not only helped develop new markets, but also helped diversify their risk portfolio.¹ This principal-agent relationship brought new complications to the industry; independent agents felt they owned their client list and their relationship with their clients, while insurers felt they could contact these clients to renew policies and avoid the middlemen. This was eventually settled in New York in 1904 when an insurer tried to renew policies by ignoring the independent agent and going straight to the policyholders. The agent sued and the courts decided in favor of the agent by upholding the independent agents claim that their client list was their property.² This decision solidified the strength of independent agents and has influenced the marketing evolution of the insurance industry.

Several studies have questioned the value of independent agents and postulate that they raise expenses for insurance companies while adding little value. Data show that independent agents are more costly to insurers through less effective economies of scale and agency conflicts.³ However, the continued existence of independent agents suggests there are likely legitimate reasons for them. Independent agents justify their existence by claiming better customer service and understanding of complex lines of insurance. D’Arcy and Doherty (1990) analyzed buying patterns in the insurance market and suggested that the insurance industry experiences buying inertia when individuals and businesses tend not to shop around after purchasing insurance.

Marketing Strategies and Cost Differentials

In modern times, insurance companies have used four different types of systems to distribute their insurance products: the exclusive agency system, the independent agency system, the salaried employee distribution system, and the mail marketing system. The exclusive agency system is when an insurance company pays a third party to sell their products who is contractually obligated to sell only that insurer’s product. For the independent agency system, the agent is allowed to sell multiple insurer’s products. The salaried employee distribution system is simply when an insurer pays fixed compensation to their own employees to sell their products. And finally, the direct marketing system is when an insurer sells their products with no intermediary.

¹Barrese & Nelson, 1992, p. 378

²National Fire Insurance Company v. Sullard, 1904

³Joskow, 1973; Cummins J. D., 1979

The existence of independent agents has allowed insurers to enter markets with less human resource risk to themselves. An insurer does not need to pay a salary to an independent agent or provide office space; they only need to provide compensation through commissions when the agent sells a policy. Growth in the number of independent agents has created economic “agency” issues that continue today. Agents try to limit contact between clients and the insurers, while insurers attempt to create incentives for agents to push their product, which often has unintended negative side effects. Once enough insurers enter a market, they are forced to compete with one another for the attention of independent agents by offering incentives to sell their products. The increase monitoring and incentive program costs are eventually passed to the customer in the form of higher premiums.

In 1973, Paul Joskow examined cost differential between direct and indirect marketing systems. Joskow found that insurance companies that wrote their policies directly, rather than using independent agents, experienced a 10.82 percentage point reduction in expenses associated with underwriting for property-liability insurance⁴. In 1979, David Cummins and Jack Vanderhei conducted another study based on Joskow’s and came to the same conclusion that insurers that used independent agents had higher expenses and suggested that regulators take a more active role in disseminating information on cost differentials to consumers.

The increased costs incurred by insurers through independent agents is often justified anecdotally by saying independent agents offer superior service, which could explain why they still exist despite the extra costs; however, several studies have suggested that clients don’t see any difference in service.⁵ D’arcy and Doherty (1990) suggest there is inertia that accompanies purchasing insurance, which means it’s unlikely for a client to change insurance after purchasing it, and also that independent agents may offer a comparative advantage in some lines of insurance but not others. Several studies have supported this which show that the market share of independent agents for private passenger auto bodily injury fell 57 to 33 percent in 1970 to 1990, while their market share for worker’s compensation went from 73 to 79 percent, with independent agents retaining 82% market share today.⁶

Barrese and Nelson argue that after the studies by Joskow, and Cummins and VanDerhei, developments in research and the potential changes in the independent agent-insurer relationship made it necessary for them to reexamine the data to gain a more accurate picture of the insurance industry.

A New Look at Cost Differentials

Barrese and Nelson propose three main hypotheses: “(1) The independent agency system is less efficient than other insurance delivery mechanisms; (2) the relative inefficiency is declining over time; and (3) economies of scale continue to exist for the industry”⁷. To answer these hypotheses, they performed an analysis that related insurance companies’ expenses to a number variables: a ratio of net written premiums (NPW), which accounts for reinsurance the company buys and sells; direct premiums written (DPW), which represents all insurance premiums received; whether the insurer is a stock company or mutual, which

⁴Joskow, 1973, p. 400

⁵See Etgar, 1976; Cummins and Weisbart, 1977

⁶Aartrijk & Flannagan, 2011, p. 32

⁷Barrese & Nelson, 1992, p. 385-386

attempts to measure costs associated with different business ownership; line of business such as workers compensation, automobile insurance, and homeowners' insurance each separately measured against total DPW; if a company uses mail marketing or salaried distribution system; the percentage of premiums written by independent agents; and the percentage of DPW by independent agents by year to measure changes over time. Compared to previous studies, Barrese and Nelson went more in-depth by looking at more variables and attempting to also adjust for changes in firm structure over time if a firm began selling more types of one insurance or began relying more or less on independent agents.

Key Findings

By measuring the different marketing systems as separate variables, rather than lumping them into two like previous studies, the authors found more useful results. The cost differential associated with exclusive agency fell between that of direct mail and independent agency firms in terms of their relation to expenses. This shows that by lumping exclusive agencies with direct mail, previous studies likely unstated the expenses related to exclusive agents by averaging it with the cheaper direct mail system.

When trying to measure for the existence of economies of scale, Barrese and Nelson replicated the Cummins and VanDerhei, and the Joskow studies. Barrese and Nelson's results contradict with Cummins and VanDerhei's findings that showed evidence of economies of scale and agreed with Joskows by "suggest[ing] an absence of scale economies".⁸ Despite this, while using DPW as an output variable and losses as an output proxy, Barrese and Nelson found that both support the idea of economies of scale with the latter providing a stronger correlation. These results highlight the difficulty with trying to use data as a proxy or variable to answer a question; depending on what you use, you can get very different results.

Although Barrese and Nelson suggest that more studies are needed, they make it clear that their study supports past work by reconfirming that a cost differential exists between independent and exclusive marketing strategies. By using more sophisticated variables and analysis methods, they were able to show that the cost differential is likely not as extreme as previously thought. The fact that independent agents still exist, despite their higher expenses, supports the conclusion that independent agents can offer valued services in less standardized lines of insurance.⁹

⁸Barrese & Nelson, 1992, p. 389

⁹Barrese & Nelson, 1992, p. 381

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