22 Insurance Distribution Systems

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Abstract

This chapter details the use of different insurance distribution systems in practice, analyzes key issues in distribution system use based on economic theories of the organization of the firm, and discusses public policy and regulatory issues related to insurance distribution. The chapter focuses on what we believe to be the three major economic issues in insurance distribution: the choice of distribution system(s) by an insurer; the nature of insurer-agent relationships, including compensation structure and resale price maintenance; and regulatory oversight of insurance distribution activities, including regulation of entry and of information disclosure to consumers.

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22.1 INTRODUCTION

Firms in the insurance industry vary along many dimensions, including product distribution systems. A wide variety of distribution methods are used in the industry. Insurance distribution systems span the spectrum from the use of a professional employee sales force, to contracting with independent sales representatives, to direct response methods such as mail and telephone solicitation. The ongoing competitive and technological revolution in the financial services industries has resulted in greater segmentation of distribution by product market, and greater use of multiple distribution methods by firms, including the establishment of marketing relationships and alliances with non-insurance concerns.

The purpose of this chapter is to detail the use of insurance distribution systems in practice, to understand their use from a theoretical perspective and to discuss public policy and regulatory issues related to insurance distribution. Two points about the

chapter are worth noting in advance. First, because much of the academic literature on insurance distribution has focused on the United States, and because we have greater access to databases on that country, most of the detailed discussion of insurance institutions in this chapter will refer to the U.S. marketplace. We make reference to insurance distribution in other countries where the data are available, but refer the reader to other sources for details on these markets.[1] The second noteworthy point is that the academic literature on insurance distribution is quite narrowly focused. There are many interesting and important issues that have received little or no attention in the literature. The approach taken in this chapter is therefore to discuss not only the state of knowledge from existing literature, but also to raise questions arising from economic theory regarding areas that need further research.

We focus our discussion on what we believe to be the three major economic issues in insurance distribution. The first is distribution system choice. Due to the variety of distribution systems employed in the industry, the differences in contractual relationships across them, and the recent market share gains of nontraditional distribution systems, an important area of research is the optimal choice of distribution system. Much of the existing research on property-liability insurance distribution has examined aspects of this question. This will continue to be an important question for both property-liability and life insurers, as the use of multiple distribution systems becomes increasingly common.

Closely linked to this question are others regarding the nature of the insurer-agent relationship. One particular area of interest is the structure of agent compensation. The differences in agent compensation structure across different distribution systems have received attention in property-liability insurance. Questions also surround the incentive effects of commission compensation schemes with regard to agent service and information provision, and, in the life insurance industry, unethical practices such as unnecessary policy replacement (often known as *twisting*). Compensation structure is also related to agent incentives to offer price discounts via commission rebating, a practice outlawed in all U.S. states until recently.

The final issue that we explore is regulatory oversight of insurance distribution activities. Life insurance sellers in many countries recently have come under criticism for misleading sales practices or high-pressure tactics. Agents have been alleged to exaggerate the benefits of their policies or fail to reveal key elements of risk to policyholders. In response to these and similar concerns, information disclosure regulation for both life and property-liability insurance sellers has been strengthened significantly in several countries, and is being considered in others. As new regulatory systems are designed, questions intensify regarding the need for such regulation, the appropriate regulatory mechanism, and the effectiveness and results of regulations.

[1] Much of our information on markets outside of the United States is drawn from Skipper, 1998, Nuttney, 1994, Hoschka, 1994, and Finsinger and Pauly, 1986.

The organization of the chapter is as follows. Section 22.2 provides background information on the different distribution systems employed in the insurance industry. Section 22.3 summarizes the state of knowledge from theoretical and empirical studies of distribution system choice by insurance firms. Section 22.4 discusses issues surrounding commission compensation and commission rebating in insurance retailing. Section 22.5 describes the regulation of insurance distribution and the potential economic rationales for this regulation. Section 22.6 concludes with a discussion of recent trends in insurance markets and their implications for insurance distribution.

22.2 BACKGROUND

Product distribution channels in the insurance industry can be classified into five types: (1) mass marketing or direct selling; (2) employee sales representatives; (3) non-employee sales agents who sell for a single company; (4) non-employee agents who sell for more than one company; and (5) brokers. Mass marketing methods are those that do not involve a sales intermediary, such as mass mailings, television or radio solicitations, and increasingly, the internet. Employee sales representatives constitute a dedicated sales force under the direct employ of a single insurer. Non-employee agents are independent from the insurer, and are typically small businesses or franchisees with a well-specified contractual relationship with a single insurer; these sales agents are often called exclusive agents. Agents with non-exclusive sales relationships are independent businesses with contractual agreements to sell the products of more than one insurer; these agents are often called independent agents. Brokers too are independent businesses who may sell the products of more than one insurer. However, unlike exclusive or independent agents, brokers have no formal contractual relationships with insurance firms and hence represent the insurance purchaser as a client. This distinction means that a broker cannot commit an insurer to provide insurance without the insurer's specific approval of the policy, whereas many independent sales agents can bind the insurer to offer a policy. In practice, however, the multiple representation opportunities of independent agents and brokers makes these systems very similar.

Because the life and property-liability insurance industries developed separately, distribution systems in life insurance and property-liability insurance differ significantly.[2] Changes in regulation and in market forces have brought greater integration of life insurance and property-liability insurance sales, as insurance firms combine and insurance agencies expand their product offerings. Nonetheless, there remain differences in the market penetration of competing distribution systems in property-liability insurance and life insurance. The contractual relationships between agents

[2] For example, in the United States, regulations prohibited an insurance firm from selling both property-liability and life insurance until the 1940s (Huebner, Black and Webb, pg. 648).

and insurers, and the functions of agents, also differ across the property-liability and life insurance industries. Some of these differences have implications for the economic issues surrounding distribution system use in the two industries. For these reasons, it is useful to characterize property-liability and life insurance distribution systems separately.

22.2.1 Property-Liability Insurance

Property-liability insurance is sold primarily by professional agents. Independent agents (including brokers) and agents tied to a specific insurance firm (whether via employment or exclusive contract) together account for the vast majority of the direct premium revenues of the industry throughout most of the world (Skipper, 1998).

22.2.1.1 Market Shares

The 1995 U.S. market shares of insurers using independent agency, brokerage or *direct writing* (exclusive agents, employee agents or direct marketing) distribution methods are reported in Table 1. The table reports the shares of direct premium revenue by these three major distribution systems for property-liability insurance overall, and for selected lines of property-liability insurance. The data are constructed from premiums reported at the individual firm level, and each firm is catalogued according to its primary distribution system.[3] Note that since some companies use more than one distribution method, the table does not provide an exact apportionment of premiums by distribution system. However, this problem is minimized by reporting at the individual firm level rather than by consolidated insurance firms (known as *groups*), because individual firms within groups may use different distribution methods.[4]

The table documents that independent agency companies have the largest market share overall, with 49.7 percent of premium volume; direct writer firms closely follow, with a 43.4 percent overall market share. Firms that distribute primarily through brokers achieve a 6.4 percent market share. There are significant variations in market shares across line of insurance, however. Independent agency firms dominate the commercial insurance lines, especially commercial multiperil and ocean marine, where they capture over three-quarters of the market. Broker distributors also achieve their greatest market penetration in the commercial lines, most notably in general liability and ocean marine insurance. Direct writer companies dominate in the personal insurance lines, controlling about 60 percent of both the automobile and homeowners insurance markets.

These dramatic differences in market shares by line of insurance preview the market share dynamics shown in Table 2. Independent agency was the earliest method

[3] The classifications are taken from A.M. Best Company's *Key Rating Guide*.

[4] Market share figures do not add to 100 percent, as there are small shares of premium volume written by firms using other primary distribution systems (general agents or mass marketing), which are not reported here.

Table 1
Market Shares by Distribution System U.S. Property-Liability Insurance, 1995

Line of Business	Independent Agency	Broker	Direct Writing
Private Passenger Automobile			
Physical Damage	35.6	1.0	62.6
Liability	39.8	2.7	57.0
Homeowners Multiperil	37.4	0.3	62.0
Commercial Multiperil	80.5	1.8	17.4
Workers Compensation	70.4	9.0	20.2
General Liability	62.0	26.2	11.5
Fire	52.7	14.3	31.8
Ocean Marine	76.4	19.4	4.0
Inland Marine	62.1	14.6	22.5
Boiler and Machinery	68.5	2.7	28.8
Allied Lines	71.0	5.9	20.7
Total	49.7	6.4	43.4

of distributing property-liability insurance in the United States, and remained by far the predominant system until the latter half of this century. Over the past three decades, however, the share of insurance sold through the independent agency system has declined significantly. This trend is documented in Table 2, which shows the change in U.S. market shares of direct writer insurers (where this category combines exclusive agency, employee agency and direct marketing) for the major lines of property-liability insurance between 1980 and 1997. Independent agency insurers experienced a 10.1 percent decrease in market share over this period, which is equivalent to a loss of 2.71 billion dollars in premium revenue for 1997. Consistent with the data in Table 1, we observe that the largest market share gains of the direct writing firms are generally in personal insurance, particularly homeowners. Market share gains have also occurred in some commercial insurance lines, especially fire and allied lines insurance. However, independent agency has made market share advances in some commercial lines during this time period, notably boiler and machinery, workers compensation and general liability.

22.2.1.2 Insurer-Agent Relationships

An important distinction between insurer-agent relationships across the different property-liability insurance distribution systems in the United States lies in which party owns the policy "expirations" or customer list. Under independent agency and broker distribution, the ownership rights to the customer list accrue to the agent. This means that the insurance firm cannot contact the customer for policy renewal or for the sale of additional products, without doing so through the agent. With exclusive

Table 2
Trends in Direct Writer Market Shares U.S. Property-Liability Insurance

Line of Business	1980 Share (percent)	1997 Share (percent)	Change
Private Passenger Automobile			
Physical Damage	60.9	69.2	+8.3
Liability	60.5	67.8	+7.3
Homeowners Multiperil	45.0	63.3	+18.3
Commercial Multiperil	12.2	19.1	+6.9
Workers Compensation	22.1	19.8	−2.3
General Liability	17.8	15.6	−2.2
Fire	24.4	37.0	+12.6
Ocean Marine	9.8	13.0	+3.2
Inland Marine	22.8	27.0	+4.2
Boiler and Machinery	33.2	25.9	−7.3
Allied Lines	20.6	30.5	+9.9

agency contracts or employee agents the insurance firm retains ownership of the customer list.

Compensation systems for the independent agents also tend to differ from those of the tied agents. Independent agents (including brokers) are generally compensated wholly by commissions. The commission rate varies across insurance products, with new policies and renewal policies often receiving the same commission rate. Many insurers also pay profit-contingent commissions to independent agents, based upon premium volume and the loss ratio of the business sold for the insurer. Exclusive agents are also generally paid by commission. Commission rates tend to be lower than those for the independent agent, and commission rates for renewal policies are lower than those for new business. There is also some evidence that exclusive agents are less likely to receive profit-contingent commissions than independent agents (Regan and Tennyson, 1996). However, other forms of compensation or company benefits, including participation in retirement plans, may be afforded exclusive agents. Employee sales agents tend to be compensated at least partially by salary rather than commission, and many are compensated wholly by salary and bonus schemes rather than commissions.

The provision of agent training and support by insurers using exclusive agents or employee sales forces tends to be greater than that provided to independent agents. Exclusive agency insurers often treat new agents as employees during a specified training period. The agent becomes an independent contractor paid on a commission basis only after this period (Rejda, 1998). Exclusive agency insurers also advertise more heavily than the independent agency firms, who may rely more on agent marketing efforts (Regan, 1997).

Customer service functions such as billing and claims processing are performed

by the insurance company under the exclusive or employee agency system. Traditionally, the independent agent himself provided most of these services for his customers. In recent times, insurers using independent agents have begun to provide these services more centrally.[5] Starting in the mid-1980s many independent agency insurers moved claims handling, premium collection, policy issuance and communication functions away from the agent to insurer-controlled service centers. Another type of restructuring is the provision of customer service functions in combinations of independent agencies rather than at the individual agency level. Under the insurer service center model commission payments to agents are reduced to reflect the reduction in agent service activities. Under the agent service center model each agent pays fees to the center to support the service provision, and insurers generally must agree to the servicing arrangements.

22.2.2 Life Insurance

As in property-liability insurance, distribution via professional agents is the dominant form of life insurance sales. In most countries, including the United States, Canada, Germany and Japan, the majority of life insurance agents are either employees or exclusive agents who sell the products of only one company. However, there are countries such as the United Kingdom where brokers and financial service advisors are more prevalent. Mass-marketing companies are making significant inroads in some countries, and the sale of life insurance products through banks is also gaining acceptance. The latter trend is particularly true in European countries, most notably France, where bank sales represent over 50 percent of life insurance premiums.[6]

The differences across life insurance distribution systems in the United States are less pronounced than those in property-liability insurance. Importantly, in life insurance there are no differences regarding ownership of policy renewals, with the insurance company typically retaining ownership under all systems. However, there are differences in the degree of vertical control of the distribution system. Insurers may operate an exclusive agency system in which independent contractors are contractually bound to sell the products of only one insurer. This is commonly called the career agency system, where the insurer invests heavily in recruiting and training a dedicated sales force. The career agency force may be directly managed by the insurer through a branch office network, or through non-employee managing general agents who operate with the authority of the insurer. Insurers may also be represented by independent agents or brokers with non-exclusive representation contracts. In this case, the insurer's control of the distribution channel is much looser, and the insurer does not invest in agency building.

[5] See Anderson, Ross, and Weitz, 1998, for a discussion of the creation of more vertically integrated relationships between independent insurance agents and insurers.

[6] These data are from Skipper, 1998.

22.2.2.1 Market Shares

U.S. life insurance market shares by distribution system are presented in Table 3. The table shows the share of total premiums generated by each distribution system for each major product category in 1995. The data are constructed from reports at the individual firm level, and each firm is catalogued by its primary distribution system. It should be noted that although most firms do have a primary distribution system, it is relatively rare for a life insurance firm to use a single distribution method for all products and markets (Carr, 1997). Hence, the market shares reported here are only an approximation of true premium shares by distribution system.

The table shows that the most prevalent method of distribution is the career (exclusive) agency system. Career agency firms have a 78 percent market share overall; non-career (independent) agency distributors obtain a 16.4 percent market share, and mass marketing insurers take the remaining 5.6 percent. Market shares for life insurance products are even more skewed toward career agency, especially in ordinary and group life, which account for the bulk of life insurance premiums. However, annuity sales account for the majority of total life insurance and annuity revenues (62 percent using 1995 data), and both independent agency insurers and mass-marketers obtain greater market shares for annuity products. The independent agency market share in individual annuities is 31.6 percent, and in group annuities it is 22.1 percent. Mass marketers achieve a 12.7 percent share of the individual annuities market and a 9.0 percent share of the group annuities market.

Total premium volume represents premiums collected in a particular year, irrespective of when the original policy was sold. Due to the long term nature of most policies in this industry, market shares by total premium volume will thus overstate the share of current sales for a distribution system experiencing market share declines, and understate the share of current sales for a distribution system experiencing market share gains. To provide better evidence on market shares of current sales, and to

Table 3
Market Shares by Distribution System U.S. Life Insurance, 1995 Total Premium Volume

Line of Business	Career Agency (percent)	Independent Agency (percent)	Mass Marketer (percent)
Ordinary Life Insurance	89.5	7.6	2.9
Group Life Insurance	85.3	9.6	5.1
Credit Life Insurance	65.5	5.1	29.5
Industrial Life Insurance	96.8	2.4	0.8
Individual Annuities	55.7	31.6	12.7
Group Annuities	68.9	22.1	9.0
Total	78.0	16.4	5.6

provide some insight into market share gainers and losers, Table 4 presents the market shares of each distribution system using new premium volume rather than total premium volume. New premiums are those arising from the sales of new policies in the reported year.

Table 4 shows that, relative to the share of total premiums, independent sales agents achieve a greater share of new annuity premiums, especially group annuities. In group annuities, the independent agents' share of new premiums is 62.1 percent, although its share of total premiums is only 22.1 percent. In group annuities this increase comes solely at the expense of the career agency system, with the market share of mass marketers also slightly higher than their share of total premiums. Both the career agency and independent agency systems achieve higher shares of new premiums than of total premiums in the individual annuity market, with mass marketers experiencing a decrease. The market shares of new premiums and total premiums in life insurance lines are relatively constant for all distribution systems, except for group life and credit life, where mass marketer shares of new premiums are higher. This increase comes primarily at the expense of the independent agency system. Taken together, these findings indicate that market shares for annuities are more fluid than market shares in life insurance products, with the career agency system losing significant market share to the independent agency and mass marketing distribution systems.

22.2.2.2 Insurer-Agent Relationships

In the United States, life insurance agents with ties to a single insurer are organized under branch offices or managing general agents of the insurance company. Under the branch office system, the selling agents report to the regional office, and agent recruitment, training and oversight are often provided at this level of the organization. Under the general agency system the managing general agent is an independent contractor

Table 4
Market Shares by Distribution System U.S. Life Insurance, 1995 New Premiums Only

Line of Business	Career Agency (percent)	Independent Agency (percent)	Mass Marketer (percent)
Ordinary Life Insurance	90.9	7.0	2.1
Group Life Insurance	85.9	7.0	7.1
Credit Life Insurance	63.9	3.9	32.2
Industrial Life Insurance	98.7	1.3	0.0
Individual Annuities	58.9	36.2	4.9
Group Annuities	26.3	62.1	11.6
Total	69.8	24.0	6.2

who invests his own capital, and is charged with building a full-time career agency sales force for a single insurer. The managing general agent typically is not engaged in personal selling, but is paid an override on the commissions of the producing agents. As in property-liability insurance, company-provided training and other evidence of committed relationships with agents are relatively higher under these tied agency systems than under other agency systems.

Independent agency in life insurance takes two primary forms, known respectively as personal producing general agency and brokerage. Unlike managing general agents, the principal goal of the personal producing general agent is to sell insurance. Although the personal producing general agent may have a primary relationship with a specific insurer, the personal producing agent, and the selling agents appointed by the personal producing general agent, may sell the products of more than one company. Like brokerage in property-liability insurance, life insurance brokers represent the products of more than one insurer. Typically, the insurer fills the role of product manufacturer, providing products for life insurance sales outlets that may be developed by other organizations. For example, many brokerage insurers distribute their products through the independent agency forces of property-liability insurers, or through securities dealers or banks. Brokers are appointed by the insurer as authorized representatives, and are compensated solely on a commission basis.

Under all distribution systems in life insurance, agent compensation is largely via commissions. Life insurance commission schemes tend to be weighted heavily toward motivating sales of new policies, rather than rewarding renewals or profitability. A large fraction of the first year premium paid by the consumer is often devoted to the sales commission, with a much smaller percentage of annual renewal premiums (sometimes for up to 10 years) also being paid as commission. A recent survey of life insurer business practices in the United States reveals first year commission rates for individual life insurance ranging from 50 percent to 120 percent of the first year premium. These rates did not vary systematically across the distribution system employed (Wharton Financial Institutions Center, 1997).

22.3 DIRECT WRITING VERSUS INDEPENDENT AGENCY

There is a large academic literature focused on questions regarding which of the general methods of distributing insurance products is more efficient. The vast majority of these studies have been undertaken in property-liability insurance rather than life insurance. This is probably due to the greater differences in organizational relationships between firms and agents under the property-liability systems. Moreover, the historical development of property-liability distribution systems in relation to the regulation of rates in this industry has made these differences starkly apparent.

Comparative studies of insurance distribution systems typically group the various systems into two main categories, based upon the degree of vertical control of the

sales force. The two broad categories analyzed are "direct writer" and "independent agency". The direct writer category encompasses mass marketing, the use of employee sales agents, and exclusive agents. The independent agency category encompasses both the independent agency system of marketing and the use of insurance brokers.

There are two distinct bodies of literature on insurers' choice of distribution systems. The first, a largely empirical literature, compares the relative costs or profitability of the two distribution systems. These studies have consistently found that property-liability insurers using the independent agency system have higher costs than those using direct writing. The second literature attempts to interpret or explain the coexistence of the two systems in light of these observed cost differences. Early papers in this literature viewed the continued existence of independent agency as viable only in the short run; more recent papers argue that distribution system coexistence is a long run equilibrium. We begin with a summary of the findings of the cost and profit estimation literature, and then discuss the theoretical explanations for distribution system coexistence.

22.3.1 Cost and Profit Comparisons

A number of prominent studies compare the average costs of property-liability insurance distribution systems. Most of these studies use data on insurance firms or groups to estimate a regression model of insurer average variable costs, incorporating a dummy variable to distinguish firms with different distribution systems. Under the assumption that insurers offer homogeneous products and use identical production technologies, a coefficient estimate on the dummy variable which is significantly different from zero implies average cost differences across the two distribution systems.[7]

The first such analysis is by Joskow (1973), in his study of the industrial organization of the property-liability insurance industry. Joskow measures costs as the ratio of underwriting expenses to premiums (the expense ratio), and estimates linear models of the expense ratio as a function of total premium volume, reinsurance use, ownership form (stock or mutual) and distribution system. Using data on 157 fire and automobile insurance groups for 1970–1971, Joskow estimates that the expense ratios of insurers using direct writing are approximately 11 percent lower than those of insurers using independent agency.

More recent studies examine cost differences for later time periods, and incorporate model specification and data refinements to Joskow's basic analysis. Cummins and Vanderhei (1979) examine a total variable cost measure as well as the underwriting expense ratio. Total variable costs include loss adjustment expenses (costs of claims settlement) in addition to underwriting expenses. If independent agency firms are more likely to perform loss adjustment at the agent level, the costs of claim

[7] See Braeutigam and Pauly, 1986, for a critique of this methodology when insurance products are not homogeneous.

settlement will appear as part of underwriting expenses for independent agency firms but not for direct writing firms. This accounting difference could produce apparent differences in costs if measured by the expense ratio. These authors also estimate log-linear models of costs premised on a Cobb-Douglas production function. Barrese and Nelson (1992) refine the distinctions between direct writer and independent agency insurers by incorporating a continuous variable defined to be the percentage of an insurance group's premiums obtained from independent agents, and by adding an additional dummy variable for groups using direct mail methods or salaried employee distributors. They also experiment with using incurred losses as the insurer's output measure rather than premium revenue.

Even with these refinements, both sets of authors find results that are consistent with Joskow's. Direct writers are found to have lower average costs both overall and for automobile physical damage insurance separately, and the results hold under both linear and log-linear model specifications. These studies also find no significant decline in the direct writer cost advantage over time. Cummins and Vanderhei use data for the time period 1968–1979, and Barrese and Nelson use data for the period 1978–1990; neither study finds evidence that the cost difference across distribution systems is smaller in the later years of their respective sample periods.

Regan (1999) extends this type of analysis to a much larger sample of firms, and analyzes a larger variety of property-liability insurance lines. In regression models of underwriting expense ratios for personal automobile liability, personal automobile physical damage, homeowners multi-peril, commercial multi-peril, workers compensation and general liability insurance for 260 firms in 1990, Regan finds that direct writer cost advantages differ significantly across lines. Direct writers' expense ratios are significantly lower than those of independent agency firms in homeowners and commercial multi-peril insurance, but not in the other lines of insurance examined. Consistent with previous studies, however, her results show that direct writers have significantly lower expense ratios when all lines of business are combined.

Rather than testing for differences in expense ratios, Berger, Cummins and Weiss (1997) use frontier efficiency analysis to examine differences in both cost and profit efficiency across property-liability insurance distribution systems.[8] Their estimation methodology improves over previous studies by allowing for efficiency differences across individual firms rather than simple intercept shifts between direct writer and independent agency firms on average, and by estimating a multi-product cost function derived from economic theory. Consistent with the results from earlier studies, these authors find that independent agency insurers are significantly less cost efficient than direct writers. However, they find no significant differences in profit efficiency across the two distribution systems.[9] The authors interpret this finding to indicate that

[8] See Chapter 26 by Cummins and Weiss of this volume for an in depth discussion of this methodology.

[9] An earlier study by Cather, Gustavson and Trieschmann, 1985, compared the mean accounting profitability levels of 68 insurance groups for each year in the time period 1975 to 1982, and also found little evidence of profitability differences across firms using different distribution systems.

product quality or service differences underlay distribution system coexistence, reasoning that such differences will be manifested in costs but not in profits.

Several other studies have hypothesized that the higher expense ratios of independent agency insurers may reflect greater service or quality provision.[10] Etgar (1976) looks for direct evidence of quality or service differences across distribution systems by comparing the services provided by 116 personal lines agents operating in the state of California. Using data from a survey of agent practices, the study reveals that independent agents intervene in claims settlement significantly more often than exclusive agents, but finds no other significant difference in service provision. A larger survey of independent agency operations is undertaken by Cummins and Weisbart (1977), obtaining responses from nearly 700 personal lines agents in three different states. While this study finds that independent agents are significantly more likely to provide claims assistance and to review coverages more frequently than tied agents, in other areas independent agents provide less service than tied agents.

To surmount the difficulties associated with comparing multiple measures of service, and to capture service provision by the insurance company as well as its agents, Doerpinghaus (1991) measures customer service indirectly by examining consumer complaints to regulators. She posits that better customer service will lead to fewer complaints, and thus tests the hypothesis that independent agency insurers receive fewer complaints than tied agency insurers. Her empirical analysis uses data from three state insurance departments regarding consumer complaints about individual insurance firms. Regressions of each firm's rate of complaints on firm characteristics plus an indicator variable for the firm's distribution system produce no evidence of significant differences in complaint rates across the two systems. A follow-up study by Barrese, Doerpinghaus and Nelson (1995) uses complaint data from five states, a richer empirical model and tobit estimation methods rather than ordinary least squares. This study finds that independent agency insurers receive fewer complaints when the data from all five states are pooled, and in two of five individual states studied. This provides evidence of greater satisfaction on the part of independent agency customers, and hence is not inconsistent with superior service or quality provision by independent agency insurers.[11]

On balance, however, existing studies present mixed evidence of superior service provision by independent agency insurers or their agents. The focus of many of these studies on personal insurance lines may provide a partial explanation. Recall that independent agency insurers have lost significant market share in the personal

[10] Venezia, Galai and Shapira (1996) develop a theoretical model which shows that tied and independent agency insurers may coexist in equilibrium when independent agents provide greater assistance in claims processing. Under the additional assumption that consumers have private information about their risk types, it is shown that higher risk consumers will choose independent agency insurers, which will in turn offer higher prices and lower deductibles in equilibrium.

[11] Of course, if consumer complaints are made only when service fails to live up to expectations, there is the possibility that selection bias in the distribution system clienteles will affect these results. For example, if shopping with a particular distribution system is correlated with service expectations or innate tendencies to file complaints, the study results may be compromised.

lines over time. If independent agency firms enjoy a competitive advantage in service provision, but personal insurance lines are not service-intensive, this could explain both the lack of independent agent service advantages found in these studies, and the lower independent agency market share in these lines. A difficulty of interpretation arises, however, because these studies do not relate differences in service provision to the costs incurred by insurers or their agents. As a consequence, one cannot determine whether any observed differences in service provision are the source of the cost differences between the two distribution systems. This remains an open question.

The one unquestioned conclusion arising from this literature is that in property-liability insurance direct writers have lower underwriting costs on average than independent agency insurers. This cost difference has persisted over time, although it is not large, and is even insignificant, in some lines of insurance. The cost difference does not, however, translate into differences in profitability. While these findings appear to suggest that service, quality or product differences are the most likely reasons that the two distribution systems coexist, they do not rule out other possibilities. For example, even if independent agency insurers survive in the market only because of regulations that protect them from competition, direct writers could experience only normal profits if their excess profits are competed away via advertising or other non-price competition. As a second example, if consumers fail to purchase from low-cost providers due to search costs or switching costs, independent agency firms could earn supra-normal profits despite having higher costs than direct writers.

More generally, the coexistence of a high-cost and a low-cost distribution system in the industry could be simply a short run phenomenon, or it could be a long-run equilibrium. Recall that independent agency was the original distribution system in the industry, and direct writing developed later. Hence, the observed use of independent agency could be a temporary phase in the evolution of the industry. Alternatively, there may exist conditions under which independent agency is optimal for firms and consumers, despite its higher costs. Under these circumstances independent agency will continue to exist in long run equilibrium. Both of these views have been put forward in the literature, with the latter gaining greater prevalence over time. We review the arguments and evidence for each below.

22.3.2 Slow Adjustment Theories

Joskow (1973) advances a regulatory protection hypothesis for the continued existence of independent agency insurers. This hypothesis is based on the observation that, at the time of his study, direct writers had both lower market shares and higher price-cost margins in automobile insurance markets in which rates were regulated than in those that were not. Joskow argues that the direct writers are a low cost oligopoly protected by entry barriers, and their failure to take over the market is profit-

maximizing behavior in the face of short run capacity constraints and price floors created by rate regulation.

At the time of Joskow's study, insurance rates were regulated in all states except California, Illinois and New York. Joskow's conjecture became a testable hypothesis when a larger number of states deregulated insurance rates in the 1970s. Since that time, several studies have examined the impact of rate regulation on the market shares of direct writers. Most of these studies use regression models of state-wide market shares of direct writers, and test for regulatory effects by including a dummy variable for regulated states.[12] The evidence is somewhat mixed, but generally supports the hypothesis that direct writers have lower market shares in regulated markets. Contrary to Joskow's findings, however, the more recent evidence also suggests that rate regulation creates price or profit ceilings rather than price floors.

These results have several possible interpretations. First, it is possible that rate regulation reduces price competition and thereby increases the market shares of higher cost independent agency firms. Note that if rate regulation imposes price ceilings, the price advantage of low cost firms will be lower and hence their market share may be lower (Pauly, Kunreuther and Kleindorfer, 1986). Alternatively, it may be that low cost direct writer firms choose to lower their market shares in regulated states. This could occur if regulation limits firms' profits, and low cost firms can earn supra-normal profits in unregulated states (Suponcic and Tennyson, 1998). Finally, it is possible that the differences in market shares of direct writers in regulated and unregulated states are due to omitted effects that are simply correlated with rate regulation.

Analyzing state level data for the late 1970s, Pauly, Kleindorfer and Kunreuther (1986) find that the effect of regulation on direct writer market shares is greatly diminished when the 1969 market share is included in regressions as a control variable. Given that virtually all states regulated rates in 1969, this finding suggests that unobservable differences in state environments (and not regulation) are the primary determinants of direct writer market shares. Consistent with this, Regan and Tennyson (1996) find no effects of regulation on direct writer automobile insurance market shares in the 1980s once the correlation between direct writer market shares across lines of business in a state is accounted for. Similarly, using data from 1971 to 1983, Gron (1995) finds no significant effect of rate regulation on direct writer market shares when variables representing the political influence of insurance agents are included in regression models. She argues that it is the political actions of agents, rather than reduced price competition, that reduces direct writer shares under rate regulation.

An analysis of market shares by Grabowski, Viscusi and Evans (1989) suggests a different interpretation. These authors find that, in states which deregulated automobile insurance rates in the 1970s, direct writer market shares increased significantly.

[12] See, for example, Pauly, Kleindorfer and Kunreuther, 1986; Grabowski, Viscusi and Evans, 1989; Gron, 1995.

This suggests that regulation had some direct effects, at least in these states. In addition, for the late 1980s, Suponcic and Tennyson (1998) find that the growth in direct writer market shares is slower in several of the most stringently rate-regulated states, and that this effect is greatest for the lowest-cost direct writer firms. Both sets of results are consistent with the view that low cost firms choose to reduce their market shares in regulated environments.

It is important to note, however, that by the 1990s there is little difference in direct writer market shares in regulated and unregulated states on average. For example, in 1995 direct writing firms averaged a 67.1 percent market share in regulated automobile insurance markets compared with an average 68.1 percent share in unregulated markets (Cummins, Phillips and Tennyson, 1999). Moreover, as noted earlier, independent agency insurers continue to dominate in some commercial lines of property-liability insurance, in which rates tend to be less heavily regulated. Thus on the whole, although it appears that rate regulation may have slowed direct writers' growth in automobile insurance markets, the continued existence of the independent agency system does not stem from rate regulation.

Of course, market imperfections not created by regulation could sustain high cost firms in the short run. Several deviations from perfect competition have been documented in insurance markets. Information about insurance prices and quality may spread only slowly among consumers, who tend to obtain this information from family and friends (Berger, Kleindorfer and Kunreuther, 1989). Seog (1999) finds that there are conditions under which a slow learning process could prevent consumers from moving to a lower cost distribution system, even in the long run. Costs associated with finding price information could also allow high cost firms to survive in the market, as costly search will imply that not all consumers identify the lowest cost firm. Dahlby and West (1986) present evidence that price dispersion in automobile insurance markets is consistent with costly price search, and Mathewson and Winter (1983) find evidence consistent with costly search in life insurance markets. Switching costs, due for example to imperfect rating models, could also lead to some consumers using high cost firms in equilibrium. Schlesinger and von-der-Schulenberg (1992) find that consumers are imperfectly informed about insurance prices, and that consumers switch insurers only for large price reductions. This pattern is consistent with both search and switching costs.

While market imperfections could lead to the slow evolution of the industry toward the use of direct writing, little direct evidence has been presented in the literature to gauge their importance for distribution system market shares. More importantly, the idea that market failures sustain an inefficient distribution system fails to address the question of why firms would continue with the inefficient system. It has been argued that contractual constraints prevent independent agency insurers from changing systems, and agent ownership of the customer list is surely a significant barrier to change. However, some insurers have partially changed their distribution systems or instituted multiple distribution systems through divestitures, acquisitions

or new subsidiaries. The changes in insurer-agent relationships discussed earlier in the chapter also imply that independent agency is now less distinct from direct writing than in the past. Despite this, the fact that independent agency continues to serve nearly half the total market, and over 70 percent of the commercial market, casts doubt on the idea that there is no efficiency basis for its existence. A number of recent studies have examined the coexistence of independent agency and direct writing from this perspective.

22.3.3 Equilibrium Coexistence Theories

The economic theory of the firm maintains that the organizational choices of firms will be made in an optimizing manner, just as are the operating decisions of ongoing firms.[13] Under this theory, organizational form is chosen to minimize both the production and agency or transaction costs associated with incomplete information. This implies that when more than one organizational form is observed in an industry, there must exist differences in firms' operating or contracting environments which lead them to efficiently choose different organizational forms.

Within this theoretical framework, the relevant question is the identity of the key factors that determine the efficiency of one organizational form over others. Two general classes of arguments have been applied to the choice of insurance distribution system using this perspective. The first focuses on incentive conflicts between an insurer and its sales agents or its customers, and the second focuses on consumer search costs in markets for insurance.

22.3.3.1 Incentive Conflicts

Marvel (1982) theorizes that direct writing protects the promotional efforts of the insurance firm. Suppose, for example, that customers are attracted to a sales agent by an insurance firm's promotions for its specific product. If the agent sells other insurers' products as well, he may have a financial incentive to switch customers to the product of a non-advertising firm, to avoid paying a share of promotion costs passed on by the advertising firm. The customer may have an incentive to switch to this product as well, due to its lower price. This potential for free-riding will reduce the level of advertising expenditures chosen by each insurance firm dealing with an independent agent. The prediction of this theory is therefore that when insurer-level advertising is the most efficient way to increase product sales, direct writing will be used because it preserves the incentive to invest in advertising.

Marvel provides empirical support for this theory by demonstrating that independent agency insurers spend relatively less on advertising than direct writers. Evidence consistent with the theory is also provided by the observation that independent

[13] Important early works taking this perspective include Alchian and Demsetz, 1972; Jensen and Meckling, 1976, Williamson, 1979; and Fama, 1980. See Holmstrom and Tirole, 1990, for a complete review of the theoretical literature.

agency is more prevalent in commercial insurance lines where, presumably, brand advertising is less important than in personal lines. Marvel also interprets the higher commission rates of independent agents as payment for greater agent level promotional effort.

Grossman and Hart (1986) make an argument regarding investment incentives that is similar to Marvel's, but allow for moral hazard on the part of both the insurance firm and the agent. In this setting efficiency requires that ownership rights to productive assets must be given to the party whose investments most greatly affect the value of those assets, because ownership increases investment incentives. The key productive asset in insurance sales is the customer list, and hence ownership of the customer list will optimally be assigned to that party (insurer or agent) whose investments are most important to the value of the list. Firm ownership of the list will be preferred when the list size is the most important determinant of profitability, and hence the insurer's brand investments are most important. Agent ownership will be preferred when customer persistency is the most important determinant of profitability, and hence the agent's services are most important. This reasoning implies that independent agency will be used when agent services are relatively important to insurer profitability. Like Marvel's, this theory is also consistent with the prevalence of independent agency in commercial insurance (if agent services are important in building the client list in these lines), and higher commission payments to independent agents (because of agent efforts in building the client list).

Sass and Gisser (1989) theorize that direct writing reduces the costs associated with an agent's sales effort being divided among competing brands. Direct writing lowers the agent's opportunity cost of sales effort devoted to a given firm's product, which allows the firm to pay a lower commission rate per policy. The only limitations to the use of direct writing under this theory are firm and market size. In order for a firm to attract tied agents, the firm must be able to offer the agent a larger sales volume to overcome the lower commission rate.

To provide evidence for their theory, Sass and Gisser estimate a probit model of the probability that an insurance group is a direct writer. Using data on 116 property-liability insurance groups from 1974, they find that firm size and insurance market density are positively correlated with the use of direct writing. This is consistent with the view that direct writing is limited by the size of the market. In regression models of insurer commission payments, the authors also find direct writers pay lower commission rates, even after controlling for advertising expenditures and line of business specialization. This is inconsistent with the view that tied agents' commission rates are lower only due to implicit charges for insurers' advertising.

Regan and Tennyson (1996) present an alternative model of agent effort differences across distribution systems. They argue that independent agency provides agents with greater incentives to exert (unverifiable) effort in risk selection and classification. The incentive differences across independent agency and direct writing arise because the independent agent can extract a share of the residual profits from his

efforts, through his ability to place desirable risks with other firms. Tied agents with no such leverage must be compensated directly for their risk assessment efforts, even if these efforts do not lead to higher profits. Under this theory, the total cost of independent agent compensation will be greater as a result of profit sharing and commission competition across insurers. However, the marginal cost of compensating an independent agent for information gathering effort will be lower. Independent agency will thus be more efficient only when subjective information provided by the agent is important to profitable underwriting. When applicants can be sorted using verifiable information or standardized classification algorithms, direct writing will be preferred due to its lower cost.

Regan and Tennyson estimate regression models of state level market shares of direct writers using panel data for 1980–1987. Consistent with their views of the role of independent agents in risk assessment, these regressions show that direct writer shares are lower in markets where risk exposures are relatively heterogeneous and complex, and thus more difficult to classify using standardized tools. In regression models of insurer commission payments, the authors also find that independent agency insurers pay a larger proportion of agent commissions on a profit-contingent basis. This is consistent with their theory, since profit-contingent-commissions reward an agent for distinguishing profitable from unprofitable business.

Kim, Mayers and Smith (1996) focus on potential incentive conflicts between the insurer and consumer as the prime determinant of distribution system choice. They argue that independent agents should be more effective at monitoring and preventing opportunistic behavior by insurers, due to the agent's ownership of the customer list and his relationship with several insurers. Hence, independent agency should be used when agent monitoring of the insurer is important to consumers. Because policyholders are the ultimate owners of the firm under the mutual form of organization, stock insurers may require more monitoring on policyholders' behalf. This theory thus predicts a relationship between ownership form and distribution system, with independent agency used by stock firms and direct writing used by mutual firms.

Using data on 1,480 individual insurance firms from 1981, Kim, Mayers and Smith estimate logistic regression models of distribution system use which show a positive and significant relationship between direct writing and the mutual form of ownership. These results hold even after controlling for firm characteristics such as size, advertising, geographic concentration and line of business concentration. The authors also find evidence consistent with Marvel's (1982) predictions regarding differences in advertising intensity across distribution systems, and with Sass and Gisser's (1989) predictions regarding differences in firm size across distribution systems.

Regan (1997) proposes a more general transactions costs theory to determine distribution system choice. Transactions costs theory posits that the integration of functions within a firm is more likely when the costs of market transactions are high. Regan argues that integration (direct writing) is more likely when relationship-specific

investments are important, and non-integration (independent agency) confers advantages when products are complex or the environment is uncertain. The need for relationship-specific investments favors integration because of the potential for ex-post opportunism under market exchange (Williamson, 1979). Regan hypothesizes that independent agency is preferred when products are complex because of the greater need for agents to intervene in insurer/customer conflicts and the need for agent participation in risk assessment (Regan and Tennyson, 1996). Independent agency is preferred in uncertain environments because the agent's greater ability to diversify risk across insurers lowers the compensation that agents require for risk bearing.

Regan (1997) estimates logit models of the probability that an insurer is a direct writer using data on 149 insurance groups from 1990. Consistent with the findings of Kim, Mayers and Smith (1996) she finds that direct writing is positively associated with the mutual form of ownership. She also finds that direct writing is positively related to insurer advertising and technology investments, and associated with lower risk and lower product complexity. These findings are consistent with her hypothesis relating distribution system use to transactions costs. Her findings are also consistent with the arguments of Marvel (1982) regarding advertising and those of Regan and Tennyson (1996) regarding product complexity.[14]

22.3.3.2 Search Costs

There is a small strand of literature focusing on costly consumer search as the reason for the equilibrium coexistence of independent agency and direct writers. What distinguishes this literature from the literature arguing that costly search preserves an inefficient distribution system is the assumption that the distribution systems differ materially in ways other than costs. This literature notes that the search for information about insurance prices and products is part of the purchase process, and that direct writer and independent agency distribution systems differ with respect to how consumers can search for information. Under direct writing, each individual insurer must be contacted for price and product information. Under independent agency, the agent may serve as an intermediary between the consumer and multiple insurers. This difference in search processes provides a rationale for firms and consumers of differing characteristics to choose different distribution systems.

Posey and Yavas (1995) present the first formal analysis of this type. These authors model the insurance purchase transaction as requiring two-sided search, due to differences in risk characteristics across consumers and product differentiation across insurers. Independent agents act as middlemen in facilitating these matches. Shopping with an independent agent guarantees a match in a single search, while shopping in the direct writer sector requires sequential search. The model assumes that

[14] Regan and Tzeng (1999) provide additional evidence on the relationship between insurance distribution system and ownership form. This study explicitly treats the choice of distribution system and ownership structure as jointly determined, to control for the fact that common exogenous factors may influence both choices. The findings confirm the view that stock ownership and independent agency distribution are likely to be observed together.

price is exogenously set at the zero-profit level, and the only element in the search process is for appropriate coverage. Under fairly general conditions, the authors are able to derive coexistence equilibria in this model. In most of these equilibria, consumers with high costs of search choose the independent agency system.

Posey and Tennyson (1998) analyze distribution system coexistence under pure price search. Similar to Posey and Yavas, these authors assume that shopping in the independent agency sector entails nonsequential search, while shopping in the direct writer sector entails sequential search. However, in this model it is assumed that products are homogeneous and prices are determined endogenously. Under certain conditions regarding the relative distributions of production and search costs, they find that both distribution systems may exist in equilibrium. The constructed equilibrium is one in which low production cost producers and low search cost consumers utilize the direct writer sector, while high cost producers and high search cost consumers utilize independent agency.

The search-based models of distribution system choice have not been extensively tested. Posey and Tennyson (1998) show that price levels and price variances for independent agency and direct writers in automobile insurance are consistent with the predictions of a price search model. However, more direct evidence relating consumer search costs to distribution system choice is needed to test the relevance of these models.

22.3.3.3 Open Issues

The theories of equilibrium coexistence of direct writer and independent agency distribution systems yield predictions consistent with a number of features observed in the property-liability insurance industry. This congruence of theoretical predictions and observed phenomena provides support for the general view that distribution system choices have an efficiency basis. The more detailed empirical evidence discussed in the previous section also makes clear that there are substantial differences in organization, product specialization and agent compensation across firms using different distribution systems. However, given the similarities in predictions derived from the alternative theories, obtaining empirical support for one theory to the exclusion of others has proven difficult. The empirical evidence thus far suggests that many factors play a role in determining distribution system choice, and leaves open the question of their relative importance. Other studies that could advance our understanding of this question include examination of the distribution system choices of new entrants to the industry, analysis of the relative success of firms using the same distribution system, and analysis of distribution system use in relation to consumer shopping behaviors.

Two other topic areas that have not received much study may also shed further light on the determinants of distribution system use. The first of these is the choice of distribution systems by life insurance firms. Many of the conditions argued to be at work in the choice of distribution system by property-liability insurers should exist in the life insurance industry as well. Carr, Cummins, and Regan (1999) present a

transaction cost analysis of distribution system choice in life insurance.[15] Consistent with traditional transaction cost reasoning, they find that tied agency is more prevalent among life insurance firms that sell complex products.[16] Further, after controlling for product specialization and other firm characteristics, the authors find no significant differences in overall cost efficiency across life insurance distribution systems.[17]

These findings are quite distinct from the findings of studies in property-liability insurance. One intriguing explanation is that life insurance firms have optimally aligned distribution systems with product characteristics and markets, and are thus in equilibrium. Another interesting possibility is that the findings in property-liability insurance are driven primarily by the differences in client list ownership across distribution systems, which do not occur in life insurance. A final potential explanation is that there are measurement difficulties in the life insurance industry, due to the use of multiple distribution systems within a single firm (Carr, 1997), or due to omitted factors such as bank alliances or other marketing relationships. Further research into this question would be useful.

Another open question in the literature is the vertical separation between insurers and agents. The primary focus of the theoretical arguments has been on comparisons of the direct writer and independent agency distribution systems. Yet both of these systems most often involve vertical separation of the agent from the insurer; relatively few insurers utilize an employee sales force. The more natural question arising from the economics literature on transactions or contracting costs is the choice of internal versus external sales forces. Several studies have documented that insurers using an employee sales force or mass marketing have lower costs than other insurers (Barrese and Nelson, 1992; Regan, 1993; Carr, Cummins and Regan, 1999). Research examining why vertical separation is so common in insurance, and the determinants of this organizational choice, would increase our understanding of distribution system use in the industry.

22.4 AGENT COMPENSATION AND RESALE PRICE MAINTENANCE

Due to both competitive and regulatory concerns, the nature of insurance agent compensation has come under increasing scrutiny within the industry and among policy

[15] Grossman and Hart (1986) present evidence of specialization in term life insurance by independent agency insurers. However, their arguments regarding why independent agency is optimal for term life insurance rely on differences in client list ownership across the different distribution systems. In life insurance there are no such differences, with the insurance firm typically retaining ownership of policy renewals.

[16] Group insurance programs and individual whole life insurance were classified by the authors as relatively more complex than other products, such as individual term life or credit insurance.

[17] Efficiency is measured using data envelopment techniques, which decompose cost efficiency into technical and allocative efficiency. The authors find that both independent agency and tied agency insurers are less technically efficient than mass marketing insurers.

makers. Insurance agents are most commonly compensated via commissions based on premium revenues sold. Concerns center on the effects of such commission payments on agent sales and service incentives in general, and on unethical sales practices in particular.

Closely linked to the question of agent compensation is that of resale price maintenance. Resale price maintenance restrictions in the insurance industry prevent sales agents from reducing policy prices below those stated by the insurer, with agent commissions embedded in the retail price. While *per se* illegal in most industries in the United States since 1975 (Ippolito and Overstreet, 1996), this restrictive practice is not only legal but required in the insurance industry, due to state laws in effect since the 1940s. Because of the overwhelming use of commission-based compensation in insurance, these state laws are worded as "anti-rebating" laws, which prohibit agents from rebating any portion of their sales commission to the customer. A common justification for these laws is to discourage agents from needlessly replacing policies as a way of increasing commission income. Because of this link with agent compensation and incentive issues, we discuss resale price maintenance in conjunction with other issues regarding commission compensation.

22.4.1 Commission Compensation

22.4.1.1 Compensation and Incentives

Economic theories of optimal contract design lend insight into the use of commission compensation for sales agents. The perspective of these theories is that sales agents are self-interested, and hence must be encouraged to behave in ways that further the interest of the firm. It is further assumed that agents have private information about their efforts, abilities or market conditions related to sales, and that outcomes for the firm (sales or profits) are only stochastically related to agent inputs (effort or ability). The information asymmetry between the employer and the sales agent and the stochastic nature of output precludes the use of direct monitoring and enforcement of agent behaviors by the employer. In this environment, the compensation system can provide financial incentives to motivate the agent to act in the interest of the firm.

The simplest form of commission plan is to pay commissions only. Such a plan is the least costly way to motivate a risk-neutral agent to act in the interest of the firm, by directly aligning the agent's compensation with the employer's payoffs. For risk-averse agents, commission plans that involve some fixed (salary) component are preferable. Although the straight commission system provides the best incentives, the need to compensate a risk-averse agent for bearing income risk makes this form of compensation ultimately more costly. From this perspective, payment of salary plus commission reflects a trade-off between providing work incentives and sharing risk with the agent (Basu et al, 1985).

Other theoretical perspectives also predict that optimal agent compensation

schemes may involve some salary component. Marketing and organization theorists point out that straight commission schemes are poor instruments for building long term relationships (John and Weitz, 1989). Transactions cost theory notes that commission compensation does not provide agents with incentives to invest in firm-specific human capital (Anderson, 1985). These arguments imply that commission-only compensation will be preferred only when the sales force is readily replaceable; otherwise the optimal compensation scheme will also involve a salary component. In this view, the optimal weighting of salary and commission compensation reflects a trade-off between effort incentives and relationship-building.

These theoretical predictions about the merits of salary versus commission compensation appear to be borne out in the insurance industry. For example, the compensation of independent agents is often solely commission-based whereas tied agents often receive some additional fixed compensation. Some employee agents are compensated through salary and bonuses only. These differences are consistent both with the greater earnings diversification opportunities of independent agents (risk issues) and their weaker links to a specific insurer (relationship issues).

The heavy reliance on commission compensation in life insurance has recently come into question. Consistent with the theories discussed above, one specific issue cited by life insurers considering compensation system changes is the inability to form long term relationships with agents. Life insurers currently experience an average annual turnover rate for agents of approximately 26%, and an average four year retention rate of new agents of only 18% (Hoesly, 1996). Insurers' concern about the cost of this turnover suggests that the existing compensation structure may be inappropriate in the current environment for life insurance products.

22.4.1.2 Unethical Agent Behavior

It has been argued that commission compensation does not control, and may exacerbate, conflicts of interest between sales agents and consumers (Kurland, 1995, 1996). Of particular concern in the insurance industry is the agent's incentives regarding disclosure and information provision, and choice of policy or product to sell (Howe et al, 1994). For example, an agent might recommend a particular insurer's product because it generates a higher commission rather than because it is the best match for the consumer. These concerns should be especially salient in circumstances in which part of the value-enhancing input of the agent is to provide consumer information and aid in the choice of product. It is therefore not surprising that concerns about the effects of commissions on agent sales practices are particularly strong in the life insurance industry.

Whether commission compensation does in fact encourage unethical behaviors is uncertain, as research into the effects of commission compensation on sales agent behavior is scarce. Kurland (1996) surveyed insurance agents regarding their predicted actions in scenarios that involved ethical dilemmas. Contrary to her hypothesis, she finds that the percentage of annual earnings from commissions does not

affect insurance agents' ethical intentions toward consumers. A study by Howe, et al. (1994) may provide indirect evidence regarding the effect of compensation method on ethical behavior. This study finds that agents with higher customer orientation (as opposed to sales orientation) exhibit higher ethical standards in sales practices. If commission compensation encourages greater sales orientation, this finding suggests a link between commission-based compensation and unethical practices.[18]

The general marketing literature on sales practices provides suggestive evidence of a link between commission compensation and sales practices. Agents in more competitive environments are more likely to approve of unethical solutions to problems, and the operating environment is found to affect agents' perceptions of acceptable sales practices. However, this literature concludes that there is no direct effect of compensation practices on agent ethics. Rather, a complex set of factors which include the compensation system, management practices, perceived corporate codes of ethics, competitive pressures and the agent's personal ethics affect the ethical behavior of sales agents.

22.4.1.3 Alternative Compensation Systems

An often-suggested alternative to commission compensation for life insurance agents is consumer-paid fees provided to the agent (either with or without salary compensation from the insurer). Largely because of concerns about unethical agent behavior, regulatory commissions in several countries have considered mandating fee-based compensation for financial service sellers. Some U.S. states prohibit financial service agents from receiving both fees and commissions on the same transaction (Lefenfeld, 1996). The hypothesized benefit of fee-based systems is that agents compensated by fees would have no incentive to offer biased advice regarding the merits of purchase, or the relative merits of alternative products.

To highlight the issues in determining whether consumers would be better served under the alternative systems, Gravelle (1993, 1994) undertakes a theoretical welfare analysis of commission-based versus fee-based compensation systems in a life insurance market. Consistent with current public policy concerns, Gravelle assumes that agents play an important informational role in the market. The insurance market is assumed to be competitive, but agents hold a monopoly in providing consumers information about the benefits of life insurance.

In this model, all agents have a financial incentive to exaggerate the benefits of life insurance to consumers if compensated by sales commissions from the insurer. However, even dishonest agents have some social value, because they may contact consumers whose *true* benefit from life insurance exceeds the purchase price. Replacing sales commissions with fees paid by consumers may or may not improve social

[18] Eastman, et al (1996) find that the professional ethics of insurance agents are lower than their personal ethics, but do not study the relationship between compensation methods and ethical beliefs.

welfare. The quality of advice will be greater under the fee-based system (that is, agent dishonesty will be less), as generally argued. However, the fee will be set at the monopoly level, and hence too few consumers will become informed and will potentially make purchasing errors. This latter finding depends of course on the assumption that agents have a monopoly in information provision, which is questionable in the current market environment.[19] Nonetheless, Gravelle's analysis demonstrates that the relative merits of compensation systems depend not only on agent actions, but on the equilibrium prices for products and services, availability of product variety and services, and the number of agents and insurers that enter the market under alternative compensation schemes.

Another alternative to the current life insurance compensation system is to offer a more level commission structure, reducing first-year sales commissions and raising renewal-year commissions. Puelz and Snow (1995) demonstrate theoretically that high first-year commissions are optimal if agent efforts in attracting new customers are more productive than agent efforts in attracting renewal customers. However, their analysis does not consider effects that this commission scheme may have on the non-sales behavior of agents. In addition to concerns about service and information provision, it has been argued that large first year commissions engender incentives for "twisting". Policy twisting is said to occur when an agent convinces a consumer to replace an existing policy with one of no greater benefit, in order to generate commission income for the agent. While we are aware of no empirical studies of the effects of commission structure on the prevalence of twisting, it is apparent that higher first year commissions will increase agents' incentives to replace rather than renew policies.

22.4.2 Resale Price Maintenance

In the abstract, an insurance firm can be viewed as an upstream supplier of a product to an insurance agent, who adds some value to the product and sells it in the retail market. The insurer chooses the wholesale price for the product by specifying the premium for the consumer and the sales commission for the insurance agent. In the absence of legal or contractual restrictions, the agent could alter the retail price of the policy by either offering a rebate of part of his commission to the consumer, or charging a separate service fee. Resale price maintenance restrictions prevent the agent from influencing the retail price in this way. In the insurance industry these restrictions operate as a price floor, prohibiting agents from rebating commissions to consumers. Resale price maintenance restrictions have received the most attention in the life insurance industry, where agent first-year commissions are high and hence there exists significant potential for rebating.

[19] In Gravelle's model there is also no competition between agents. Consumers are contacted by at most one agent and cannot seek out advice from other agents.

22.4.2.1 Economic Issues

While there are no existing studies of the rationale for resale price maintenance in the insurance industry, economic theory identifies two possibilities: resale price restrictions may support price collusion or other anti-competitive practices, or may represent a solution to some principal-agent problem (Katz, 1990; Ippolito, 1988).

Collusion theories focus on the anti-competitive effects of reducing retail market price differences. One argument is that removing uncertainty about prices at the retail level increases the monitoring ability of a price-setting cartel. Thus, if industry conditions are otherwise conducive, anti-rebating agreements can help maintain price collusion by inhibiting secret chiseling on price agreements. Short of collusion, resale price restraints may reduce price competition by reducing consumer search, since price dispersion will be lower in a market with no retail price competition. Resale price restraints may also facilitate price discrimination, which can increase insurer profits. Uniform prices charged to all customers is a form of price discrimination if the marginal cost of product provision differs across customers, for example due to different levels of service demand (Caves, 1980).

Principal-agent theories focus on how resale price restraints may change the behavior of retail sellers in ways that benefit the producer. One argument is that price floors encourage service provision. Resale price floors prevent consumers from shopping at a full-price outlet to obtain pre-sale services, but purchasing from a discount seller. If the price floor involves a high retailer profit margin, competition among retail sellers will take the form of service competition and advertising, thereby building markets and brand reputations for upstream producers (Katz, 1990).

A similar argument refers to quality provision by the retail seller when consumers cannot distinguish product quality from retailer quality. If the level of retailer quality or service can be specified and periodically monitored by the upstream producer, the retail price floor will serve to increase the retailer's costs of dismissal for inadequate quality provision (Telser, 1960). This provides direct financial incentives for quality or service provision by the agent.

These latter theories of resale price are related to insurer arguments for resale price maintenance in the life insurance industry. It is often argued that the complexity of many life insurance products necessitates that agents provide services in the form of information provision. It has also been argued that rebating may undermine customer persistency. A customer who will purchase only if offered a rebate has a lower valuation of the product, or of the services provided by the agent, than the customer who purchases at full price. If low-valuation customers are more likely to cash in their policies early, insurers may not recover the fixed costs of selling and underwriting on these policies. Under this argument, insurers' expectations of losing money on such customers could explain resale price restrictions.

The history of the anti-rebating laws in the United States life insurance industry

offers some corroboration of this perspective on the issue. Stalson's classic book on the history of life insurance distribution makes clear that agent rebating was viewed as a problem by life insurers as early as the 1860s, and was something that insurers and agents unsuccessfully tried to deal with via informal agreements (Stalson, 1951). While the precise reasons for industry opposition to rebating are not made clear in that text, it appears that the practice created problems associated with the twisting of policies. High commission levels and the ability to rebate commissions to policyholders heighten the agent's incentives to engage in this policy turnover. In addition, if first year commissions exceed the first year policy premium it is possible for an agent to collude with consumers (those not interested in maintaining the policy) against the insurance company for financial gain. Stalson notes that in the heavy rebating era of the late 1800s competition for agents led to some first year commissions in excess of 200 percent of the first year premium, so this scenario is a possibility.

New York was the first state to outlaw rebating in 1889, and 21 other states quickly followed. However, rebating continued, and in fact intensified in the ensuing ten years. With the 1906 New York state Armstrong Commission review of the insurance industry, New York and other state legislatures enacted stricter laws which made not only giving a rebate, but also receiving a rebate, illegal. These laws were incorporated into the National Association of Insurance Commissioner's 1945 Unfair Trade Practices Model Act. Supported by the industry, the stated rationale of the legislation is to protect consumers from "unfair discrimination" and to prevent "destructive price competition".

These concerns provide a weak justification for resale price restrictions in the current regulatory environment. Solvency regulation, guaranty funds, and direct restrictions on discriminatory pricing are other tools to meet these objectives. Moreover, the public interest arguments for anti-rebating laws are strongest within the prevailing compensation system that pays life insurance agents a large first year commission. Changes to the commission structure would be a more direct way to reduce agents' incentives to twist policies or to offer discriminatory rebates.

At best, the effect of resale price maintenance agreements on consumer welfare is ambiguous. Even if resale price maintenance fosters agent service, it will enforce a uniform level of quality provision that may be greater than that desired by some consumers. For example, life insurance buyers who do not need as much information as others are forced via resale price maintenance to pay the high-information price. Resale price maintenance will also lessen price differences at the retail level. Given the empirical evidence on costly price search in insurance markets (Mathewson and Winter, 1983; Dahlby and West, 1986), this will reduce consumer search with negative implications for consumer welfare.

22.4.2.2 Recent Developments

Empirical research on the impact of resale price restraints in insurance markets is needed to more fully understand the issues surrounding their use. Recent events

provide some opportunity for such study. In 1986 the state of Florida repealed its anti-rebating law after it was declared unconstitutional by the state Supreme Court. California repealed its law in 1988 with the passage of Proposition 103, which contained a provision overturning rebating restrictions. No other state has yet followed suit, and anti-rebating laws have survived constitutional challenges in several states.

Trade press accounts note that the effects of rebating have been modest in the two states that have allowed it. It is argued that there are several reasons for this. First, in both states insurers are allowed to refuse to deal with discounting agents. Second, Florida has put restrictions on rebating practices to assure that the market abuses seen in the earlier rebating era are not revisited. Important provisions of the law include the requirement that agents prominently display their rebate schedules, and offer equivalent discounts to all customers. Although this provision has not been explicitly written into California law, the state's strong anti-discrimination laws may make agents and insurers feel that this restriction would apply. Thus, in order to offer rebates an agent must operate solely as a discount agent or broker. This may lower agent participation in rebating.

Although limited, the experiences of California and Florida provide at least some basis for empirical explorations of the impact of rebating. Russell (1997) uses state-level data on life insurance surrender activity for the period 1960–1992 to examine the effect of rebating on policy replacements. The study develops a regression model of surrender activity which includes a dummy variable equal to one in the states and years for which rebating is allowed. In all model specifications employed, the estimated coefficient on the rebating dummy variable is positive and significant, indicating that state surrender activity is higher when rebating is allowed. Interpretation of this positive correlation is difficult because there are no data available to determine whether the policies surrendered were replaced with other policies, and there are a very small number of observations in the data for which rebating activity was allowed. Nonetheless, these results warrant further research into the question.

22.5 THE REGULATION OF INSURANCE DISTRIBUTION

The regulation of insurance distribution is extensive in virtually all countries with developed markets for these services.[20] Insurance distribution is regulated in two distinct ways: the set of market participants is restricted, and the marketing practices of insurers and their intermediaries are regulated. Entry restrictions take the form of licensing requirements for insurers, agents and brokers, and regulations that prohibit insurance sales by certain types of firms (e.g., banks) or methods (e.g., direct mail). Market conduct regulations take such forms as requiring dissemination of certain

[20] These policies and regulations tend to be similar in intent to those directed toward marketing practices in other financial services industries.

types of information, and prohibiting misrepresentation and false advertising. Regulations are often directed at both insurance companies and insurance agents or brokers, but insurance companies also are typically held responsible for the actions of their representatives.

22.5.1 Entry Regulation

22.5.1.1 Major Regulations

Entry restrictions for insurance producers and sellers exist in virtually all countries, but the focus and extent of these restrictions varies greatly. Until recently in the United States, the Glass-Steagall Act prohibited commercial banks from entering other financial services industries, including insurance. However, exceptions had always been allowed for certain state-chartered banks, and banks serving very small markets. Further, banks are very active in the credit life and mortgage insurance markets. Even before repeal of the Act, court and regulatory rulings allowed some banks to own insurance subsidiaries and to engage in insurance distribution. Bank alliances with insurance companies are becoming increasingly common, and banks are becoming a significant distributor of annuities in the United States.

In most European countries there have historically been fewer restrictions on bank involvement in insurance. While all European Union countries prohibit banks from engaging directly in the production of insurance, most allow banks to own insurance subsidiaries and to distribute insurance products (Hoschka, 1994). The formation of insurance subsidiaries by banks is growing, and insurance distribution at bank branches is quite common in some countries. Strong restrictions on banks selling insurance remain in other countries such as Japan, however. Until recently, Japan also prohibited other insurance distribution systems such as direct selling and brokerage (Skipper, 1998).

In most countries both insurance companies and sales agents much be licensed. Licensing requirements for insurers generally include financial standards and ethical standards for company officers. In the United States, licensing is done at the state level and firms must be licensed in all states in which they do business on an admitted basis. Each company has a primary state of domicile, however, and it is this state that takes primary responsibility for regulatory oversight. In the E.U., the single market directives require insurers to be licensed only in their home country rather in each country in which they intend to sell insurance. The home country retains responsibility for solvency oversight of the insurer.

Licensing requirements for agents and brokers typically entail meeting certain ethical standards and passing a written test, but standards vary greatly across jurisdictions and often the requirements are minimal. Moreover, in many countries the licensing requirements apply only to independent agents, financial advisors and brokers; employee sales agents often need not be licensed. However, due to the growing complexity of insurance products, the move toward price and entry deregu-

lation in many markets, and to recent problems with marketing practices in some countries, professional standards for insurance intermediaries are receiving increased attention in many countries.

The standardization of agent licensing requirements and licensing reciprocity across jurisdictions is another important issue across the individual states of the U.S. and across countries, especially those of the European Union. Not only do licensing requirements vary, but agents often must be licensed in each jurisdiction in which they sell. These barriers to agents operating across borders are eroding, however. In the U.S., a 1998 NAIC Model licensing reciprocity agreement would require participating states to eliminate countersignature[21] laws, and allow producers licensed in good standing in a participating state to be eligible for streamlined licensing in any other participating state. Uniform licensing and education requirements are also being developed. Similar developments are occurring in the E.U., and in 1996 a proposal to harmonize agent licensing and regulation was forwarded (Skipper, 1998).

22.5.1.2 Economic Issues

Legal restrictions on the entry of banks into insurance are rationalized by concerns about the stability of the financial system and about detrimental effects of market power in financial services delivery. While both of these concerns have some theoretical and historical foundations, it is not clear that prohibiting entry is a necessary response to the potential problems. In countries that allow banks to enter insurance, laws still prohibit direct ownership and funds co-mingling at banks and insurance firms. This reduces the risk that banks will use insurance assets to meet liquidity needs, and makes regulatory monitoring easier. Empirical studies also suggest that the overall risk of a combined banking-insurance entity could be lower than that of either one separately (Santomero, 1993).

Market power in financial services provision is a serious concern as bank markets are becoming increasingly concentrated. However, an alternative to entry restrictions is to mitigate abuses by market conduct regulation. Moreover, allowing greater entry into insurance markets should foster competition in those markets and spur efficiency-enhancing innovations. Thus, while many complex regulatory issues remain to be resolved, allowing bank-insurance combinations may be economically sound.

Licensing requirements for agents are often justified as protecting consumers from incompetent or dishonest practitioners, and often are imposed with the support of the regulated industry or profession. The efficiency argument for industry support is that incompetent or dishonest sellers create negative externalities for other sellers by undermining industry reputation. However, there is also a political argument for industry support based on the fact that licensing requirements act as barriers to entry into the market. The requirements are sufficiently lenient that this argument seems weak in most markets. However, differenceing in licensing requirements across states

[21] In the United States, agents may sell insurance in states in which they are not licensed, but must obtain a countersignature from a licensed agent, who also shares in the commission.

or countries do limit entry, thereby protecting resident agents and insurers from competition. In addition, differential licensing requirements for independent versus tied agents may increase the costs of distribution through independent agents or brokers relative to other systems.

Even if licensing does not serve to raise entry barriers and limit competition, there is the additional question of whether licensing requirements provide any benefits to consumers. Studies of the impact of licensing restrictions in industries other than insurance tend to show no significant quality improvements obtained from licensing. Benefits from licensing insurance agents may be particularly low, since imposing liability on insurance companies for the actions of their agents may give sufficient incentives for companies to choose honest agents and provide adequate training. Although differences in agent licensing requirements across jurisdictions and changes in requirements over time make it possible to examine its effects empirically, to our knowledge this has not been studied.

22.5.2 Conduct Regulation

22.5.2.1 Major Regulations

Market conduct in distribution is a major focus of regulatory oversight in insurance. Virtually all countries have legislation in place to regulate insurance company and agent practices in the marketing of insurance. For example, the 1945 Unfair Trade Practices Model Act of the National Association of Insurance Commissioners (NAIC) defines and prohibits: the misrepresentation of policy benefits, terms and conditions, dividends or premiums, and the financial condition of the insurer; false, misleading or deceptive advertising about the business of insurance or the business of a specific insurer; agent misrepresentations on insurance applications in order to get a fee or commission; and agent misrepresentation of himself as a financial advisor.[22] This legislation has been adopted in whole or in part by all U.S. states.

Additional legislation has been adopted in many U.S. states to specify in more detail the allowable marketing practices of companies and agents offering life insurance and accident and health insurance. Advertising regulations adopted by some states move beyond general proscriptions against certain types of practices to provide detailed instructions regarding elements of policies that must be disclosed in advertising materials. Virtually all states have also adopted legislation regulating the activities of insurance agents with respect to the replacement of life insurance and annuities. This legislation requires agents to fully inform the buyer of changes in terms and conditions of insurance under the new policy, and to have the buyer sign a statement indicating knowledge that a replacement policy is being issued. The agent must include a statement on the policy application that indicates whether a policy is being

[22] Commission rebating is also prohibited in the Act.

replaced, and the buyer must be given a free-look period to compare the replacement policy with the existing policy.[23]

Another aspect of life insurance regulation is rules regarding illustrations of projections of death benefits and cash values. All states have regulations specifying the nature and content of materials that must be disclosed to potential purchasers, including allowable methods to calculate the yields of different types of policies. Sellers are also required to provide Buyers Guides and other comparative information on forms approved by the state commissioner.

The NAIC recently developed more stringent rules on illustrations for whole life, universal and term life products in the United States, designed to prevent exaggerations and to ensure that consumers understand the hypothetical nature of the projections. Even more stringent disclosure rules have been introduced in several other countries, including the United Kingdom, New Zealand and Australia. New rules in force in the U.K. since 1995 institute more realism in life insurance illustrations, require agents to document that they gave the "best advice" to each insurance applicant, and require agents to fully disclose their relationships with insurance firms and the compensation that they receive from any sale.

The weakest link in market conduct regulation is discovery and enforcement. In the United States, each state insurance commissioner has broad powers to investigate insurer and agent practices, to issue cease and desist orders and to invoke fines or revoke licenses if violations of the law are found. In other countries enforcement authority may be shared between state or provincial and federal regulatory agencies, and in some other countries enforcement authority lies with industry self-regulatory bodies. A significant problem is that investigations are costly and are most effective at the level of the individual agent; this implies that abuses may go on for a long time without being discovered. Another impediment is the lack of information sharing and coordination across jurisdictions, a growing concern among the U.S. states and the individual members of the European Union. This latter problem may be mitigated somewhat in the U.S. as the NAIC implements its producer information database. This database aims to collect and disseminate information about licensed agents in every state, including licensing status and disciplinary actions.

22.5.2.2 Economic Issues

Economic efficiency rationales for government intervention into sales and distribution practices are generally couched in terms of information problems, especially information asymmetries between sellers and buyers.[24] A central information problem

[23] Replacement of a policy with one that does not significantly increase insurance or other benefits is costly to the consumer because of the high levels of commission that go to agents at the time of sale. Other detrimental effects may include higher premium rates because the consumer is older, loss of cash value in the policy, and new incontestability and suicide clauses imposed in the new policy.

[24] These issues are discussed extensively in Ippolito, 1988.

that consumers face in insurance markets is judging product quality. The quality characteristics of an insurance policy are difficult to ascertain due to the complexity of the contract, the contingent nature of many of the services provided (e.g., claims handling and payments), and the fact that many services are provided over time (e.g., investments). This implies that quality is difficult to ascertain in advance of purchase, and may continue to be even after significant experience with the product.[25] Under this circumstance insurance sellers may have a financial incentive to charge a high price but to provide low quality. From this perspective, government regulations that prevent false or misleading advertising and that mandate full disclosure of relevant policy features may improve consumers' ability to estimate product quality at the point of purchase. Disclosure of relationships and commissions can be justified as making consumers aware of potentially biased incentives of the selling agent.

Arguments against disclosure regulation are often couched in terms of market responses to these problems. One argument is that firms have reputational incentives to maintain faith in their products and thus to provide high quality products. However, this mechanism may work imperfectly in markets for personal insurance because of consumers' limited opportunities to observe many aspects of quality. Moreover, the nature of insurance policies and their pricing is such that information may be difficult to compare across consumers. This may reduce the information content of negative consumer experiences, and hence mitigate adverse effects on reputation.

Another argument is that insurers have an incentive to provide information that is valued by consumers, because the consumer can be charged for it by the bundling of insurance products with information. This may be the case, for example, with sales through a professional agent. In this circumstance high quality producers have an incentive to inform consumers about quality. However, to the extent consumers may obtain information about insurance and then use this to purchase elsewhere, the incentive to provide information is reduced. Thus, if a significant fraction of information provision in the insurance sale is of a general educational nature, information may be under-provided in the unregulated market.

If individual insurance companies have insufficient incentive to provide quality information to consumers, other market entities may arise to provide this information. For example, consumer publications may provide general information and quality comparisons. However, because information of this sort is not proprietary, there will still be free-riding problems and hence likely under-provision of the information. Similarly, an industry cooperative association may provide educational materials that would benefit the sales of all companies, but would not have the correct incentives to provide company-specific information or comparative information across companies.

[25] At least as significant for consumers is the possibility that product quality may change after the purchase is made. Even if quality can be determined at the time of purchase, it may vary over time and hence continuous monitoring is required. This problem may be mitigated by solvency regulation and regulation of other insurer practices.

Given the nature of information problems in insurance markets, it is not clear that the market alone will provide sufficient information to insurance consumers. Hence, government intervention could improve the working of the market. The optimal form of intervention and the benefits of current regulatory measures are uncertain, however. It is possible that detailed regulations on information provision do not improve consumer decision making. Additional information may not be processed efficiently by the consumer, and large amounts of information may even exacerbate information-processing problems. The appropriate level of detail in the regulatory standards is also uncertain given the costs of compliance to insurance companies.

There also may be unintended side effects of disclosure regulation that can harm consumers. For example, the "best advice" requirements in the U.K. have been argued to lead to a move away from independent agency, since this form of distribution carries a greater disclosure burden. If independent agency distribution enhances price and quality comparisons, then the net effect of the rules could be to increase consumer search costs and reduce consumer information. Additional research is needed to evaluate the necessity of regulation and the best methods of achieving regulatory objectives.

22.6 CONCLUDING REMARKS

The deregulation and increasing integration of financial services markets, technological progress and changing demographics have resulted in a vast expansion of financial products and providers in direct competition with the insurance industry. For property and liability risks, the development of inexpensive hedging methods that are substitutes for insurance products has reduced the share of business risks covered by traditional insurance to less than 50 percent as of 1996. Even medium size businesses increasingly make use of self-insurance, captives and risk retention groups. The alternative risk transfer market has seen growth averaging six percent per year since the mid-1980s, about twice the growth rate in the commercial insurance market (Andre and Sudowsky, 1997).

In the life insurance market, demographic shifts, longer life expectancies in retirement, and reductions in benefits from government retirement plans have reduced the demand for traditional life insurance products and increased demand for annuities and other financial planning products. Sales of ordinary life insurance continue to decline each year, while annuity sales increase at a rapid rate (Hoesly, 1996). This shift in product demand has increased insurers' competition from banks and investment houses, which are licensed to sell investment products and tend to have lower distribution costs.

At the same time, in both property-liability and life insurance markets technological progress and competition have resulted in increasing standardization of the simpler insurance products. For these products there is an increasing emphasis on

low-cost distribution, and non-traditional methods of reaching customers are an important area of growth in this sector. Direct response selling has attracted interest from even the more traditional insurers, as communication technology advances, including the internet, make direct response more cost-effective. Insurers are also focusing on worksite marketing programs for simple products. These programs differ from the traditional group insurance programs in that customers pay their own premiums and insurers use individual underwriting. The aim of this marketing approach is simply expense reductions through administrative and marketing cost savings. These new distribution methods have been most effective for products such as automobile, homeowners, credit and term life insurance, standardized products for which price is seen as an important factor in the buying decision. These forces have put considerable stress on traditional insurance distribution systems, and produced pressure for innovation.

Two important trends are becoming visible in insurance marketing relationships: the use of multiple distribution systems within a single firm, and increased specialization of the roles of different distribution systems. The industry is moving away from a set of fixed relationships between insurer and agent based upon company traditions, toward a more flexible system in which the distribution method is determined by the product and the customer base. Professional agents are increasingly focused on the sale of complex, service-oriented products such as commercial insurance or other hedging instruments in property-liability markets, or estate and accumulation products in life insurance markets. Low-cost direct response alternatives are becoming more common for standardized insurance products. Some industry analysts predict that the tied agency system will be the ultimate loser in this shift, as it has neither the advantages of independent advice and service provided by brokers, nor the low costs of the direct selling alternatives (Nuttney, 1995).

The increasing polarization of distribution systems by product and market is in keeping with economic theories of the firm that predict organizational structures will be chosen to minimize both operating costs and transactions or agency costs. While existing academic studies of distribution system choice have focused primarily on the choice between an independent or a tied agency force, current market trends distinguish more clearly between fully integrated distribution without the use of professional agents versus the agency system of distribution itself. This appears to be due to both technological and competitive changes in insurance markets.

As the professional agent's role becomes more specialized, and as increasing numbers of insurance products are being sold without the benefit of agent advice, market conduct and disclosure regulation will become increasingly important in the industry. Professional certification and regulatory monitoring of agents must receive more attention in the service-oriented sectors of the industry. Consistent with approaches in other financial services industries, disclosure issues will likely become the key enforcement tool for standardized insurance products sold via direct marketing. Issues surrounding resale price maintenance and the potential for agent dis-

counting should become less important, as price-sensitive products are increasingly sold through alternative means.

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