THE STATE OF THE MARKET

"How Niche Marketing has Evolved and Where it is Going"

The segmentation of products and markets has been quietly evolving in the insurance business over the past 30 years. The catalysts for change to a more segmented industry structure have been competition, expense control and the specialization of business generally.

The result has been the development of so called Niche Product markets. At Echelon, we believe Niche Products fall within three categories.

1. Ancillary Products, being additional or supplementary products that are sold as a complement to the main purchase made by the consumer. Examples include Creditor Insurance, Warranties, AD&D and other products attached to a consumer product or service.

2. Affinity Products, being product packages or stand-alone products sold to groups who are aligned through common employment, occupation, profession or other association. Examples include E&O insurance and industry specific insurance programs.

3. Surplus Lines Products, including hard-to-place business not normally available from standard market insurers. Examples include Pollution Liability, higher risk or non-standard Property, Inland Marine, Course of Construction and higher risk Accident and Sickness.

<u>The Old Days</u>

In the early 1970's (you remember those!), most Commercial Lines insurance products were generic in nature. The broker contacted the underwriter with the risk particulars and the underwriter provided a quote for the coverage, subject to the standard commercial insurance forms and endorsements used by the insurer.

If customization or a risk specific coverage was required, it was strictly up to the broker to request the endorsement or rider be added to the policy. There were virtually no special packages for retail stores, offices, manufacturers or contractors. Insurance policies were custom built, with standard, but generally not "industry specific", coverages. In many respects, this approach suited the times and evolution of business in Canada. Most small businesses were "mom and pop" enterprises that were built to the individual owner's personal tastes and there was not a great deal of uniformity within risk classes.

Over time, insurers realized that it was far less expensive to create pre-packaged coverages that suited the majority of small retail store and office owners, which could be rated and issued by the broker without needing an underwriter to quote prior to binding the risk. Once the mental barrier of broker-issued pre-packaged policies was overcome, many new packages and industries were added to the packaged product lines available from insurers.

Along the way, brokers recognized an opportunity to create products more suited to their customers' needs. They began creating their own products targeted to consumers in affinity markets where the broker had knowledge of the business and relationships to generate sales. Although broker-initiated programs have been around for a long time, the development of this type of business has accelerated in the past 15 years.

Segmentation and specialization of insurance products has, in many ways, evolved with the Canadian economy and commercial development. Specialty retailers have replaced the once ubiquitous department stores as the driving force in that business and are now the recognized brands that dominate whole product categories. Franchising revolutionized the food service business. The majority of restaurants are now operating under a franchise banner, supported by extensive advertising and brand development.

The need for greater specialization and segmentation has affected the insurance industry in other ways. Underwriters have taken a close look at their own business operations and have decided to pare back their activities to the areas of the business where they have proven expertise, rather than trying to write every type of risk offered to them. The result has been tighter underwriting parameters, fewer exceptions made and a longer list of excluded classes. For most insurers, "If the risk doesn't fit our profile, we **prefer** not to write it" has become "If the risk doesn't fit our profile, we **will not** write it". This approach has been described as "class underwriting" and is currently more the result of strategic planning by larger insurers, rather than the traditional market cycles. The effect on the marketplace has been the development of an industry segment of niche insurers accepting business through MGAs and other intermediaries that is now larger than it has been at any time in the past 30 years.

The Niche Insurer/MGA market has grown for a number of reasons.

1. Most insurance brokers' business is driven by Personal Lines. As a result, their prime focus is on retaining insurers who will write their Home and Auto business. Many insurers who are effective in Home and Auto are not interested in operating a diversified Commercial Lines insurance business. As a result, many brokers who focus on Personal Lines might only have two or three markets. These markets will often have a fairly restrictive list of commercial risks that interest them. If the broker obtains a client whose profile does not match the preferred risk of his insurance markets, the broker will have no alternative but to look to a wholesale MGA to place the coverage in order to retain the customer.

   Often the Personal Lines broker will run into situations where one or even two of their markets will underwrite the risk, but they are restricted in their capacity and can't write the entire line of business. The wholesale MGA becomes the method of filling the line using capacity it has pre-arranged with its niche insurers.

2. Insurers realize that the expense of visiting and maintaining a brokerage relationship in Commercial Lines requires a critical mass. If a broker is too Personal Lines focused, they will not have sufficient volume to justify providing the support needed to maintain a relationship. By working with a wholesale MGA to obtain business from smaller producers, the niche insurer can transfer that maintenance cost to the MGA, making it a variable, rather than a fixed cost.

3. Insurers recognize the need to have 'spread of risk' not only on an overall basis but within a specific class of business. Wholesale MGAs can bring significant volumes of business to the niche insurer. If the wholesale MGA specializes in a limited number of industry classes, they can provide sizeable volumes within certain types of business. This stabilizes the niche insurer's results, as a larger group of similar risks will have normalized experience, as the law of large numbers takes effect.

4. For business that has low loss frequency but potentially high severity, insurers need to control underwriting procedures, develop specialized expertise and build up large volumes of business to insulate themselves against "shock losses". This has led to specialist insurers and MGAs for Pollution Liability, Accident & Sickness, Marine business, high value Homeowner and higher risk Commercial Property.

The outcome of the segmentation of markets and specialization of expertise has been felt most dramatically by insurance brokers. In order to satisfy their clients' needs, they must be able to do more than analyze the customers' exposures and recommend appropriate insurance coverage. They must also be able to match the clients' needs with a niche insurer and/or MGA who can provide the product needed for the client. This search has become time consuming. Standard insurers revise their underwriting template every year and brokers get a surprise when something that was acceptable last year is not on the list of acceptable classes for this year. This leads to the need for brokers to cultivate many relationships in order to ensure they have markets available to look after their customers.

Ultimately, the effect of a restricted market is felt by Commercial Lines businesses which see premiums increase dramatically or available coverage limits fall below the amount of coverage they feel they need. The result of increased prices and restricted markets is often a search for alternative risk financing. This phenomenon has also increased dramatically in the past 30 years in response to market conditions. Once an alternative risk transfer facility is created, it is usually here to stay. As time marches on, more and more large corporate clients and large associations have begun to retain some or all of their risk through various risk pooling and retention arrangements.

Clients or groups of clients (and their brokers) often require a niche insurance company to assist them in the structuring and developing of a viable risk retention program. The niche insurer can provide risk coverage for amounts required in excess of the retention and "fronting" of the retention where required by law, as in the case of mandatory automobile insurance coverages. The insurer can also provide unbundled adjudication and other services on the retained claims, as well as management of the group's pooled funds, including investment services.

In certain cases, an owned insurance or reinsurance captive (or rent-a-captive alternative) may be the best vehicle to carry the client's retained risk. The broker or niche insurer can organize a team of legal and accounting professionals to assess the viability of and make recommendations on any proposed structure.

At Echelon, we believe that market segmentation and the growth of niche insurers will continue, as standard carriers become fewer, get larger and tighten their focus on commodity Personal Lines. Niche opportunities exist in both Personal and Commercial Lines for brokers and MGAs to create successful programs, by aligning themselves with flexible niche insurers, who can offer a wide range and various combinations of services to meet the specialized needs of clients.

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Echelon underwrites a wide variety of producer-initiated, niche property and casualty insurance programs, which address the special needs of policyholders. Structures including an element of risk retention by the client, members of the insured group or the intermediary are also a specialty.