How Partnering with a Professionally-Managed MGA can Improve Results and Moderate Soft-Cycle Market Pressures

For many in the market, "MGA" is a four-letter word. Poorly-managed MGA's have generated a negative reputation that sours the perception of the entire MGA model. Valid criticism includes the seemingly obvious foolhardiness of "giving away the pen", the lack of alignment or even conflict of interests between the MGA and the capacity provider, and the lack of transparency for and control by the capacity provider.

However, a truly professionally-managed MGA can more than adequately address these potential flaws and offer a number of distinct advantages for capacity providers. These advantages include easy and efficient entry and exit, lower ongoing costs, a structure that enables superior underwriting, and reduced impact on and of market pressures.

What differentiates a "Professionally-Managed" MGA from the others?

"All MGA's are not created equal". As with any corporate entity, there are a number of criteria that differentiate the good ones from the others. Capacity providers should concentrate on the following questions:

- Does management have a successful track-record?
- Does the MGA provide transparency, welcoming inspection and suggestions for improvement or do they try to avoid such controls? In other words, can you trust them and have confidence in their commitment to continuous improvement?
- Is there reason to have confidence that they can underwrite their segments and select risks better than average? Is there reason to believe they can develop and manage a portfolio with good risk-return dynamics?
- Do they have a lean operation that will enable them to underwrite more selectively?
- Do they welcome a compensation system that ties most of their upside potential to the underwriting results they produce for you?

How can the potential flaws of an MGA model be addressed?

We highlight three valid criticisms of the MGA model:

1. Foolhardiness of "giving away the pen"
2. Misalignment or even conflict of interest between the MGA and the capacity provider
3. Lack of transparency for and control by the capacity provider

Foolhardiness of "giving away the pen"

On the surface, the doctrine of "We don't give away the pen" seems like common sense. However, if one thinks a little deeper on the topic, one should realize that almost every large, complex underwriting organization gives away the pen to someone. Many give underwriting authority to their underwriters as employees. Giving (or selling) away the pen, is the very product that a treaty reinsurer provides. Any "follow the leader" co-insurer or reinsurer gives away the pen as well.

The difference is the degree of trust and confidence, and the manner of control the capacity provider has. Granting underwriting authority to a professional organization under contractual controls and with adequate governance and monitoring can be just as reasonable and perhaps even less risky than granting underwriting authority to distant underwriting managers, unaffiliated treaty cedants or lead underwriting organizations.

Misalignment or even conflict of interests between the MGA and the capacity provider

Most MGA's are compensated by an MGA fee that is a function of premium volume plus a profit commission. The more the overall compensation is based on premium volume, the more misalignment exists with the results-dependent capacity provider. Over the longer-term, this misalignment is not particularly significant, as every MGA knows that any capacity provider will not continue to renew if the results generated by them are unsatisfactory. However, in soft-cycle years when most participants struggle to cover their expenses, the misalignment can be quite dangerous.

Of course, the same dynamic exists with employed underwriting managers fearful of losing their jobs if they don't write enough premium or ceding or following insurers that know they must write enough volume to cover their expenses and / or minimum and deposit premiums.

The key to addressing this is simply to shift a greater proportion of the total MGA compensation to results as opposed to volume. Of course, this effectively shifts some of the short-term soft cycle risk and consequences of writing smaller volumes to the MGA from the capacity provider. This can be addressed in different ways, including a longer-term contract or some form of protection for the MGA that is not as dangerous to the capacity provider as underwriting gone astray.

Lack of transparency for and control by the capacity provider

The key to most potential MGA model shortcomings is ensuring the capacity provider has reason to trust and have confidence in their MGA partner. Obviously, developing and maintaining such confidence is of utmost importance to the professionally-managed MGA. This all ties directly back to the criteria listed above as the differentiating factor between professionally-managed MGA's and the others.

One of the most important such criteria is the degree and quality of transparency and monitoring. The ability and willingness of the MGA to report openly and subject itself to underwriting audits and criticism should be a clear reason for the capacity provider to have confidence or not.

There does need to be a balance. A capacity-provider that re-underwrites every contract and replaces their judgement for that of the MGA underwriter defeats the purpose of the MGA, effectively turning them into another broker in the supply-chain, likely unneeded and inefficient for that purpose.

In our view, the MGA should report their transaction level activity frequently and openly, their management should hav a frequent and ongoing dialogue with the capacity provider, and they should have a welcome and open attitude towards underwriting audits. The capacity provider should not experience surprises.

We note that, as with the other potential flaws of an MGA model, this dynamic is not fundamentally different with an internal employee-based or ceding company-underwriting model.

How can an MGA model generate superior results and moderate competitive pressures?

We highlight four distinct advantages of partnering with a professionally-managed MGA for capacity providers:

1. Easy and efficient entry and exit
2. Lower ongoing costs
3. A structure that enables superior underwriting
4. Reduced impact on and of market competitive pressures

Easy and efficient entry and exit

Participating in a chosen market segment via an MGA can often be arranged within a few months or even weeks. The MGA takes care of the underwriting infrastructure and processes, hiring and firing, reporting mechanisms, claims management when desired, client and broker marketing and relationships as well as various other functions if and when desired.

In contrast, the time and cost of internally implementing all of the required internal functions, including identifying, employing, and managing the right people with the right skills can be dramatically higher.

Withdrawing from a segment written by an MGA on your behalf, can rarely be easier or less expensive. You simply do not renew the contract or apply the contractual terms that enable the capacity provider to terminate the contract.

Lower ongoing costs

There can be several reasons why a professionally-managed MGA will be the lowest cost solution:

1. A modern, professionally-managed MGA should have a state-of-the-art, lean operation where all mechanical[1] steps of the underwriting and transactional processes are fully automated.
2. A professionally-managed MGA servicing more than one capacity provider can effectively spread many of the costs among multiple capacity providers.
3. Most underwriting units of complex, large insurance groups are burdened with excessive infrastructure, bureaucracy, and legacy issues. As an alternative, a professionally-managed MGA can offer a guaranteed, relatively low contractual expense rate with automated reporting.
4. No transaction level involvement required of capacity providers
5. Scalability: MGA's can expand rapidly or scale down depending on market conditions

[1] as opposed to analytical or judgmental

A structure that enables superior underwriting

An underwriting operation with low costs that can be spread among many capacity providers can be more selective by writing a small, top quality, well-priced portion of market segments while still achieving adequate volumes to cover expenses. The end result for capacity providers is a better than average portfolio delivered at lower cost than most competitors' underwriting operations.

As an example, if we compare two underwriting organizations that have different costs as a percent of premium:

1. ACME Complex Insurance Group writes a market segment at a relatively competitive internal cost of 16% of premium and adds a 25% margin on top of costs so they need to keep 20% of premiums, leaving 80% for incurred losses and external costs such as brokerage.
2. Selective and Efficient MGA writes a market segment for multiple capacity providers at an internal cost of 8% of premium and adds a 25% margin on top of costs so they charge their capacity providers 10% of premiums, leaving 90% for incurred losses and external costs such as brokerage.

In order to cover their internal costs and required returns, ACME must write at least what they consider the best 20% of the business they see, declining at most 80%.

In contrast, Selective and Efficient only has to write what it considers the best 10% of the business they see and can afford to decline as much as 90%. In a soft market such as today's, this can make the difference between profits or losses for capacity providers.

Reduced impact on and of market competitive pressures.

Let's again consider a hypothetical example. Consider a market segment with 10 capacity providers, each with their own active, quoting underwriting infrastructure and organization. 5 new capacity providers want to enter the segment because alternative diversifying investments don't seem as attractive right now. If these 5 new participants follow the traditional route, they each incur the costs of developing and implementing their underwriting organizations, including poaching a few expensive underwriting managers from existing players, pushing staffing costs up for the whole market.

The overall result: significant overall costs added to the market, 15 underwriting organizations quoting prices, the lowest of which usually setting the market price. None of the new organizations have much market presence (or if they do, it is the result of low pricing). There are 15 underwriting teams that fear losing their jobs if they don't write enough business to cover their costs.

In contrast, if these 5 capacity providers choose to partner with an existing professionally-managed MGA, there are no new underwriting infrastructure and organizations to develop but probably some costs to expand one organization. Instead of adding five mouths that need to be fed from the same table, there are no new ones but one bigger one that needs more food. Overall, there are much lower overall costs. That one bigger player likely has stronger negotiating leverage than each of the five independent new active underwriters in the previous scenario.

In conclusion, while an MGA model may not be the right fit for all capacity providers, if the MGA is professionally managed and the delegated underwriting authority agreement is structured in a manner that aligns and balances interests between the MGA and capacity provider, it can be a very strong strategic option to consider.