

INSURANCE INDUSTRY PRIMER

for InsurTechs

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Insurance Industry for InsurTech Noobs

So you developed the newest insurance innovation that is going to revolutionize the industry – congratulations! But we also have a couple of questions:

- *What sector of the industry?
Property & Casualty? Life? Health? Title?*
- *Where in the revenue cycle is your innovation going to make the biggest difference?
Distribution? Underwriting? Claims? What about Finance or Reinsurance?*
- *Will your innovation be regulated and if so by what jurisdictions?
Just the state you're doing business in? All 50 states? The Feds?
How long does it take to obtain those licenses and permits?*

If you think these sound like arbitrary questions of an ancient industry that is resistant to change and ripe for innovation, you wouldn't be too far off. But knowing why the questions are being asked in the first place and the appropriate answers to each will allow you to refine and target your innovation to not only have the greatest impact on the industry, but also a higher likelihood that your investor pitch will land on receptive ears, particularly when you are conversant in the insurance regulatory compliance matters that affect your great new insurance idea.

A Deloitte study on InsurTech has found that traditional insurance companies are avoiding startups that don't understand their industry and that "InsurTechs need to refine their pitches to align to real-world challenges for insurers, while demonstrating both industry and technical expertise ... [and know] ahead of time where legal and compliance issues might arise."

To that end this publication is intended to provide InsurTech startups with a primer on how the insurance industry really works (that way you won't sound like a total noob when you are walking the floor of InsurTech Connect).

So let's start with the basics.

What is Insurance?

If you google the official definition of insurance, you will likely come up with something like this:

"'Insurance' means any agreement to pay a sum of money, provide services or any other thing of value on the happening of a particular event or contingency or to provide indemnity for loss in respect to a specified subject by specified perils in return for a consideration. In any contract of insurance, an insured shall have an interest which is subject to a risk of loss through destruction or impairment of that interest, which risk is assumed by the insurer and such assumption shall be part of a general scheme to distribute losses among a large group of persons bearing similar risks in return for a ratable contribution or other consideration." Conn. Gen. Stat. §38a-1(10).

If your eyes glazed over before the third line we don't blame you. This business loves to be very specific about everything, which often leads to a lot of mind numbing legalese (just take a look at any of your insurance policies if you dare).

But all insurance truly is, at its heart, is an insurance company making a promise to a bunch of people (who each pay the insurance company) that if something unexpectedly bad happens to any one of them the insurance company will pay (either directly or by paying for services, such as in health insurance) a larger amount of money than what was paid to them in the first place. The insurance company in turn is making a very calculated bet that it will collect enough money from enough people that it will have enough money to pay out claims when they occur and that it is statistically highly unlikely that it will have more claims for payments than money in its reserves. In short, insurance is risk of loss financing.

However, because no one wants their insurance company to be insolvent when they file a claim, the states heavily regulate the industry to ensure that insurance companies are not only open and transparent with consumers during the sales process, but that they also maintain very healthy levels of capital, surplus and reserves so that insurance company insolvencies are not common occurrences. This public policy driven regulation, which often unintentionally serves as roadblocks to innovation, is where many InsurTechs get tripped up early in their development, especially those startups coming from an agile software development background where iterative and fast moving changes are second nature. Unfortunately, filing new policy forms, obtaining different licenses or rolling out new claims handling processes all take longer than most InsurTechs expect and often requires that InsurTechs have talent with prior industry specific experience within their ranks. Furthermore, these regulations vary not only from state to state, but also based on the type of insurance coverage.



The Four Major Types of Risks that Insurance Covers

The insurance industry generally can be broken down in four main sectors based on the type of risks or unexpected events covered:



PROPERTY & CASUALTY:

Think of your car insurance, home insurance, etc. Something breaks or gets lost and the insurance company pays you money to repair or replace it.



LIFE:

Think of life insurance and annuities as basically two sides of the same coin. Life insurance protects your family and loved ones from running out of money if you die too soon, annuities protect you from running out of money if you do not die soon enough.



HEALTH:

Not just major medical insurance (the type of coverage required by Affordable Health Care/ Obamacare), but also vision, dental and limited benefit policies as well.



TITLE:

One of the odd ducks of the insurance industry. Basically guarantees that the piece of property you end up buying after your InsurTech is bought by Amazon is actually owned by the person selling it to you.

Generally, insurance companies that cover one type of risk (such as property & casualty) do not cover any other type of risk (like life or health). While this is largely due to restrictions imposed by state regulators, it would also be unfeasible from an efficiency standpoint as the major cost and profit drivers for each segment are significantly different. For example, profitability for most traditional life insurers is driven by

figuring out the likelihood of whether you will die during the term of the policy, mortality risks. In contrast, the profitability of many health insurers is directly correlated to how well it can reduce the cost of healthcare being provided to its insureds and morbidity risks. Obviously, it would be difficult for a company to be focused on both things at once.

Key Revenue and Cost Drivers for Every Insurance Company

Despite these differences, the game for nearly all insurance companies is:

- getting more people to buy and renew insurance policies so that the likelihood of the unexpected happening to any given person decreases to statistically predictable levels, (i.e., “Distribution”);
- creating better ways of predicting when, how often and to what degree unexpected things will occur or figuring out how to accurately price coverage for new lines of business (who thought drone insurance would be a thing two years ago); (i.e., “Underwriting”);
- decreasing the costs associated with paying for services associated with the unexpected, including decreasing the frequency of unexpected events (i.e., “Claims”); and
- managing their finances better so that the money they do have to pay for unexpected events grows as quickly as possible while still being safe and secure (because you wouldn’t want your insurer to bet all of its money it’s holding to pay your claims on a complex commodity hedge involving brick, wood, wool, wheat and ore). (i.e., “Finances and Reinsurance”).

If you can figure out how to help insurance companies: (i) increase Distribution, (ii) develop more accurate Underwriting for existing or new lines of business, (iii) reduce the cost and/or frequency of Claims or (iv) get better returns from their Finances, you will have the insurance industry beating down your door — although to be honest they will more likely politely knock and take about twice as long to come to a decision about investing in your company as you will want. Remember this is an industry based on careful and measured evaluation of risk, and no matter how amazing your InsurTech company is, it still represents risk to an industry which traditionally only devotes its resources to the most financially secure investments. Your job is to convince the industry and interested investors that the bigger risk is not investing in your innovation and being left behind.

Understanding Licensure and Top 3 Regulatory Issues for Distribution, Claims, Underwriting and Finance/Reinsurance Focused Start Ups

Again, every insurance company in the industry (regardless of the type of insurance sold) relies on four key areas for its success: distribution, claims, underwriting, and finance. In each of these four areas, there are at least two levels of regulation: licensure requirements and restrictions on your actions. While it may seem at the beginning that obtaining and maintaining licenses is the largest hurdle to clear, it is often the underlying regulatory regimes that are the more arduous because the business of insurance is regulated on the state level, requiring nuanced attention to the differences and trends under each state’s laws.

DISTRIBUTION

The main goal of Distribution in the insurance industry is the acquisition and retention of customers. Because insurance is a business reliant on the “Law of Large Numbers,” the more data points customers an insurance company has, the more likely that reality will conform to its underwriting models and there will be a larger and more diverse risk pool to absorb losses. As such, without Distribution the industry turns into one large thought exercise (RIP Schrödinger’s cat). Distribution-focused InsurTechs come in many forms. There are those that sell policies for multiple insurance companies (acting as a type of KAYAK for insurance coverages), those that develop killer API, those that develop more pinpoint lead generation, and those that simply focus on working with insurance companies to develop better UI and mobile platforms – because everyone now wants to do things with a click of a button. Unfortunately, our predecessors didn’t have modern technology in mind 50+ years ago when a number of the nation’s insurance laws and regulations were written. Robust distribution also creates cross-selling opportunities for other insurance and related financial services products and services.

Distribution-Related Insurance Licensure

Whether you will need a license in the Distribution space really comes down to two key issues: (1) are you “selling, soliciting or negotiating” insurance coverage and (2) do you want to be paid based on a percentage of the successful sales? If the answer to both of those questions is no, you likely will not need an insurance-related license for your Distribution focused activities.

However, if the answer is yes to either of those questions, then you will probably need to be licensed as an insurance agency. Moreover, because insurance is regulated on a 50-state basis (the gift that keeps on giving to us insurance regulatory lawyers), not only will you need a license in your primary place of business, but you will also likely need one in every other state (assuming you want to sell to people and companies from sea to shining sea). But the good news is that within the realm of insurance regulation, insurance agency licensure is relatively straightforward.

In short, licensure as an insurance agency requires that at least one officer or director also be individually licensed, which requires that person submitting an application and passing an exam in the person’s resident state. Once licensed in a resident state, the National Insurance Producer Registry (NIPR) provides for an efficient process to get licensed as a “non-resident” producer in all 50 states (and, for the most part, will not require duplicate testing in non-resident states).

... insurance is a business reliant on the “Law of Large Numbers” ...

It is important to remember that separate insurance licenses are required to sell P&C, A&H and Life. And, if you pride yourself on adventurous and non-standard insurance coverage, you may also need to consider a surplus lines broker license as well, which allows you to sell coverage that standard licensed insurers won't cover. Finally, if you plan on doing both sales and underwriting (and anticipate providing a significant amount of a particular insurance company's business), you will likely need to comply with managing general agency licensing and other regulatory requirements as well.

Three Key Regulatory Regimes to Know for Distribution-Focused InsurTechs

1 E-Commerce: While "one-click" optionality and paperless delivery sound great, it's important to note that insurance laws still require "paper" in many situations. For example, while the vast majority of states allow for the delivery of policies by email, there are still about a dozen that do not. Furthermore, many states still require non-renewal and cancellations to always be delivered by old fashion U.S. mail. Also, while "wet signatures" are generally no longer required, there are important requirements to follow when obtaining e-signatures. All of these requirements often are a surprise to InsurTechs who assume that the insurance industry operates like the rest of modern day commerce.

2 Anti-Inducement Laws: One of the tougher concepts that InsurTechs often have trouble grasping is that they are generally not allowed to provide potential insureds with benefits for signing up for insurance. In short, the general rule of thumb is you can't offer a potential customer any benefit that is not included in the four corners of their insurance policy. While there are always exceptions (we are looking at you California and Zenefits), unless it's something *de minimis* (think beer koozie) or otherwise included in a filed policy, it probably will be considered an illegal rebate. So, sorry, you can't give away an iPhone with every life insurance policy sold. And don't worry, we'll explain another day about how certain life and health insurers are, in fact, providing Apple Watches to their policyholders.

3 Privacy and Data Security Laws: Privacy concerns permeate every facet of our lives, and that includes the world of insurance. Of crucial importance, New York and handful of other states have implemented regulations that place new cybersecurity requirements to ensure businesses protect their customers' confidential information from cyber-attacks. Furthermore, if you are handling health information, you may be subject to HIPAA and its state counterparts, something that requires special consideration given the potentially serious penalties for related data breaches. You also have the alphabet soup of other federal laws and their state counterparts, including GLBA, FCRA, telemarketing and CAN-SPAM. Taken together, given the severe penalties associated with non-compliance, privacy and data security may be the most important issues facing every InsurTech company handling customer data.

CLAIMS

The area of Claims is where the rubber really hits the road for the industry. The last thing a customer wants is a long drawn out "battle" with *their* insurance company to get paid after they just suffered a loss (be it an auto accident, unexpected medical bills, or a death in the family). But a quick, efficient, and seamless claims process is also the best way for carriers to engender customer loyalty. The goal for insurance companies and InsurTechs in this space is the balancing of speedy payments and preventing overpayments (both through human error and insurance fraud).

Claims represent a high-potential opportunity for insurers to increase their operational efficiency. Innovative tools such as telematics, the internet of things and drones, allow insurers and claims adjusters access to more data and information in real time, which speeds up the whole claims process from prevention (everything from telemedicine preventing ER visits to automated messages from water boilers when they need repairs before a catastrophic failure), to loss notification (smart phones have made a once tedious process incredibly efficient), to assessment (it's much easier and safer for drones to see roof damage from a hurricane than having a person climb a rickety 20-foot ladder), to adjustment and payment (using AI to detect insurance fraud in big data).

Claims-Related Insurance Licensure

For the most part, the insurance regulators primarily are focused on the assessment, adjustment and payment portions of the Claims process from a licensing as well as a fair claims settlement (how you treat your customer that has made a claim) standpoint. As such, if you move past developing the technology and licensing it out to insurers to use directly (think SaaS) and actually engage in the process of claims adjusting, you will need to be licensed under the laws of the state you are working in.

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Unlike insurance agency licensure, which is relatively the same across the various lines of business, claims adjusting is bifurcated between the P&C side (claims adjuster licenses) and the A&H / Life side (third party administrator and utilization review organizations). On the P&C side, claims adjusting licenses are further broken down between public adjusters (those that represent policyholders) and traditional claims adjusters (who represent the insurance companies). As with insurance agent licenses, there are both individual and corporate licenses that need to be obtained and licensure is required in both resident and non-resident states. Thankfully, NIPR exists for claims adjuster licensing as well, so once you get your resident state license expanding into other states is relatively painless (from a licensure standpoint!). Also, some states will allow for exemptions from various adjuster or third party administrator licenses when agency or other various licenses are held.

On the health side, it's a whole 'nother ball game. Because claims handling is one of the core components of the definition a "third party administrator," InsurTechs who are actually adjusting claims in the A&H / Life space likely will need to go through the relatively time-consuming process of obtaining a TPA license in most states. Unfortunately, because TPA licensure also grants underwriting authority, the TPA licensure process is much more involved than a P&C adjuster license. In addition, if you are on the health side of things and addressing the medical necessity, appropriateness, and efficiency of health care services, your startup will also need to be licensed as a utilization review organization in more than a handful of states. As with TPA licensure, obtaining URO licenses is not as "easy" as simply taking an exam and filling out an application. Because of the relatively heavier lift on the licensure side of things, we see more InsurTechs focused on providing the technical infrastructure to insurance carriers and established TPAs and UROs through SaaS and similar arrangements.

Three Key Regulatory Regimes to Know for Claims-Focused InsurTechs

- 1 E-Commerce:** Yep. Again. Understanding when and how consumer notices and claims submissions can be submitted online vs. paper is as crucial in Claims as it is in Distribution.
- 2 Data Security and Privacy:** We promise, laziness is not the cause of us reusing these issues. Because nearly every aspect of the Claims process involves obtaining additional information from not only the carrier's insureds, but also third parties, InsurTechs in the Claims space have to be especially aware of the data flowing through their systems and ensuring that proper protocols are followed to keep the information private and used only for permitted purposes and to prevent data security breaches.

- 3 Mandatory Disclosures and Timelines:** For those InsurTechs involved in the managing of the Claims experience, getting a handle on mandatory disclosures and claim payment timelines is often a steep learning curve. Failure to acknowledge, pay, investigate, or deny a claim within the statutorily mandated timeframe can lead to fines, lawsuits, and the revocation of your license. While you may be thinking, "I can write these rules into an app," it is important to realize that it can become increasingly difficult to meet these deadlines when large scale catastrophes hit, as they increasingly have in the last few years.

UNDERWRITING

Underwriting is the bedrock of insurance. One could argue that without the rational and reasoned pricing of insurance, the industry would be little better than betting on whether a coin will land heads or tails. Fortunately, actuarial science and experiential loss history data has grown a great deal over the last few centuries. Insurance actuaries attempt to model everything from the weather (just think about what hail damage can do to crops), to the likelihood of future car accidents (even those that "weren't your fault"), to how long you will live (a necessary evil for life insurance and annuity pricing).

As you can imagine, Underwriting and Distribution go hand in hand. If an insurance carrier's actuarial models are too conservative (i.e., seeing risks behind every lurking corner), their premiums will be higher and it may be tougher to sell the coverage. On the other hand, if the carrier's models are not risk averse enough, premiums may be so low that the company won't collect enough to cover all of its claims. The goal for InsurTechs in this space isn't to lower the price of coverage, but to offer more accurate models, which in some cases may mean higher premiums for some. In addition, InsurTechs can help carriers develop underwriting guidelines for brand new areas of coverage, from insuring the cannabis industry to providing drone insurance to fantasy sport injury insurance (yes, that's really a thing). This is where predictive analytics can change the game.

Of course, underwriting standards are driven by market forces and insurance regulation as well. While the most successful insurance carriers will often separate themselves by developing sophisticated and accurate actuarial methods, if the competition consistently offers lower premiums for similar coverage, a tough decision will need to be made as to whether to deviate from actual analyses or even whether to enter to marketplace at all. In addition, depending on lines of coverage (and whether insurance is written through the admitted or "surplus lines" markets), rating guidelines are often imposed on insurance companies from the states themselves in order to protect both the consumers (from unduly high premiums) and the carriers (from offering unsustainable quotes).

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Underwriting-Related Insurance Licensure

For purposes of this analysis, we are assuming you are not forming or buying your own insurance carrier, something we'll cover in greater in the next section. The good news is that unless your InsurTech has the ability to force a carrier to actually issue a policy (in insurance parlance "bind coverage"), you likely won't need an insurance-related license to run your Underwriting-focused business. As with the prior section on the Distribution and Claims side of the house, Underwriting licensure requirements largely depend on whether your InsurTech is focused on the P&C or A&H / Life.

With respect to P&C underwriting, if your InsurTech is in charge of Distribution, Claims and Underwriting for a carrier for a line of business, there is a good chance that your carrier partner will refer to you as a Managing General Agent, or "MGA." While in all likelihood your InsurTech does not meet all the criteria necessary to meet the regulatory definition of an MGA (spoiler, you likely won't produce enough premium volume at first), carriers will likely require that your contract with them containing all of the same statutorily mandated provisions. The good news is that, assuming your InsurTech is already licensed as an insurance producer, there are no additional licenses to obtain and the contract provisions are generally not too onerous (although notably you will likely need to obtain a Surety Bond in favor of the carrier with a value between \$100k – \$500k).

Notably, if your InsurTech is not engaged in Distribution or Claims, and is instead solely focused on Underwriting, there is very little in the way of licensure for P&C products. While this may seem odd on its face, especially given what we said above about how crucial Underwriting is to the industry, it is important to remember that one of the main benefits of any licensure regime is as a signaling device to consumers that an entity is trustworthy to do business with. Consequently, because Underwriting is not consumer facing, there is less of a need for an entity to be licensed, especially when the underlying insurance carrier is already subject to substantial regulation on its Underwriting.

In contrast to the above, the A&H / Life space is governed by Third Party Administrator licensing requirements.

As with our discussion in the section above, because the standard statutory definition of a TPA is so broad (and unlike the MGA laws utilizes the word "or" instead of "and"), if your InsurTech does have the authority to bind coverage for a carrier based on your Underwriting then you likely will need to obtain a TPA license or registration, where applicable.

Three Key Regulatory Regimes to Know for Underwriting-Focused InsurTechs

1 Restrictions on Underwriting Factors: In general, insurance laws require Underwriting and resulting rates that are not excessive, inadequate, or unfairly discriminatory. While relatively clear on its face, regulators over the years have used this general principle to restrict everything from the use of credit scores, to price optimization, to blackbox underwriting. In fact, New York regulators have issued guidance that puts life insurers on notice regarding their statutory obligations when utilizing Big Data and algorithms in their underwriting. Also, remember that for major medical health insurance, PPACA is still technically the law of the land, and therefore there is generally little to no underwriting in the individual and small group market.

2 Privacy: One of the key ways InsurTechs are disrupting Underwriting is through the collection of more and more individualized data. From the devices in your car tracking every illegal U-turn you take to that free Apple Watch or Fitbit you got along with your life or health policy, all of that data is uniquely personal. And while that's great from an Underwriting perspective (especially after you spent the last 20 minutes shaking your arm while sitting on the couch to trick that Fitbit into thinking you were running – but did you just commit insurance fraud?), it means that there is a greater chance that all that personal data may be exposed or stolen. Knowing your obligations under both the relevant laws and, just as importantly, your contract with the carrier is crucial to your InsurTech's survival.

3 Understanding Rate Filings: While rate filings may be a bit of "blocking and tackling," understanding even the basics of SERFF (note – no one calls it by its full name: The System for Electronic Rates & Forms Filing) will likely set you apart from many of your competitors. In addition, knowing if your Underwriting algorithms are impacting rates which are "file and use" vs. "prior approval" will also be useful in your pitches to industry insiders (hint: it's almost always better when you don't need to get approval to do something). Unfortunately, the same rate filing may be filed and used in one state, while requiring prior approval in another. Just another joy of 50-state regulation.

FINANCE AND REINSURANCE

Because of the implicit trust the public must put in insurance carriers when they purchase a policy (i.e., that the carrier will be around and have enough money if/when a claim is made), insurance carriers are subject to a staggering amount of regulation and restriction on the types of investments they can make in order to keep them ready to pay claims. When combined with the fact that insurers often have assets running into the hundreds of billions of dollars, even incremental improvements in managing both a carrier's assets and liabilities can result in profound impact on a carrier's bottom line.

In addition to traditional asset management, one of the unique ways that the insurance industry often manages its liabilities is through reinsurance, which is essentially one insurance company (the "cedent") buying insurance from another (the "reinsurer"). At its heart reinsurance is about an insurance carrier spreading its risks to other insurance carriers to mitigate potential downside of losses. Just like insurance carriers who sell to the public, reinsurers also deal with Distribution, Claims, Underwriting and Finance issues, with the main difference being that their counterparty is another insurance carrier, not the public.

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One important fact to remember is that, in a typical reinsurance arrangement, the reinsurer is liable only to the cedent, not to its insureds. Therefore, the cedent is generally free to enter into any contractual arrangement it would like in order to offload some of its risk, provided that in order to “take credit” for the risk ceded away (i.e., have its home state recognize that it has ceded risk away for reserve purposes), the reinsurer and the reinsurance agreement must meet certain qualifications, as discussed further below.

Finance- and Reinsurance-Related Insurance Licensure

By and large there are no insurance-specific licenses required to manage an insurance carrier’s finances; however, it is possible that if you are providing investment advice to a carrier or issuing reports or analyses regarding securities and getting paid for it, you likely will need to be registered as an “investment advisor” with the SEC.

On the reinsurance side, if your InsurTech is engaged in helping cedents find coverage from reinsurers, you will likely need a reinsurance broker license. Think of this as the reinsurance equivalent of a producer license. In turn, if your InsurTech is helping reinsurers manage their operations, including underwriting, you will want to research whether you will need a reinsurance manager license (think TPA/MGA type activities).

Three Key Regulatory Regimes to Know for Finance and Reinsurance-Focused InsurTechs

1 Understanding Investment Restriction Regimes: Generally insurance carriers usually only invest in what are called “Admitted Assets” (i.e. those assets that regulators allow them to account for on their balance sheets). Not only must these assets be highly stable, they also usually must be liquid. As such, Admitted Assets usually include mortgages, stocks, bonds, and government obligations, although insurance carriers can often invest in “riskier” investments (such as equities) but such investments are usually limited to a small percentage of total Admitted Assets. Layered on top of the “Admitted Asset” regime are additional requirements related to asset liability matching and risk-based capital requirements. RBC requirements attempt to ensure that carriers have capital appropriate to support their operations in consideration of their size and risk profile. Any Finance-focused InsurTech hoping to manage a carrier’s investments should tailor their product to account for these restrictions on a granular level.

2 Understanding How Reinsurers are Regulated: Reinsurers and reinsurance transactions are subject to substantially different regulatory regimes than ceding companies, in part because the transactions are between two sophisticated entities. In general, the regulations focus on when and how ceding companies are able to take credit on their financial statements for the risks they shifted to their reinsurers. At the most basic level, under these regulations reinsurers have to show they can back up their promises to pay, and if not reinsurers will need to post some form of collateral. Because posting collateral is inherently inefficient, and because many reinsurers are located outside the United States, regulators and the industry are constantly working to eliminate this impediment. For example, through the U.S. and EU Covered Agreement.

3 Reinsurance Related Privacy Issues: Because of the huge amount of data flowing back and forth between ceding companies and reinsurers, blockchain offers huge potential technological efficiencies in the exchange of information. While the immutability of data on a blockchain makes it attractive for the reinsurance industry, blockchain platforms and service providers need to be aware that they may not only be caught up in U.S.-based privacy and data security requirements, but also those found in the EU and other international jurisdictions. And if you thought penalties and fines for data breaches in the United States were high, European regulators have fined Google \$57 million for violations of the EU’s GDPR.

Running Your Own Insurance Company: Three Options for Renting, Buying or Building the InsurTech Carrier of the Future

In this section, we delve into perhaps the biggest step an InsurTech can take – running their own insurance company. Maybe not as awesome as running, say, the L.A. Dodgers, but it really is the only way that an InsurTech can be fully in charge of all four key aspects (Distribution, Claims, Underwriting and Finance/Reinsurance) of an insurance carrier.

While operating as a managing general agent or third party administrator gives you substantial control of Distribution, Claims and Underwriting for a carrier, in most cases managing general agents (MGAs) and third-party administrators (TPAs) are not at ultimate risk for the losses under the insurance policies and therefore only receive a portion of the ultimate profit generated by their efforts on behalf of the carrier. And although it's true that the proportion of those profits can increase if the MGA / TPA is willing to take on some of the downside risk in the form of contingent commissions based on underwriting results, ultimately InsurTech's options for retaining "complete" control are limited to:

- Utilizing a Fronting Carrier
- Buying a Shell Insurance Carrier, and
- Forming its own Insurance Carrier

We find it useful to think of these as the insurance equivalent of renting a house, buying an existing home and building a new home.

Option 1: Fronting Carriers – Renting A House

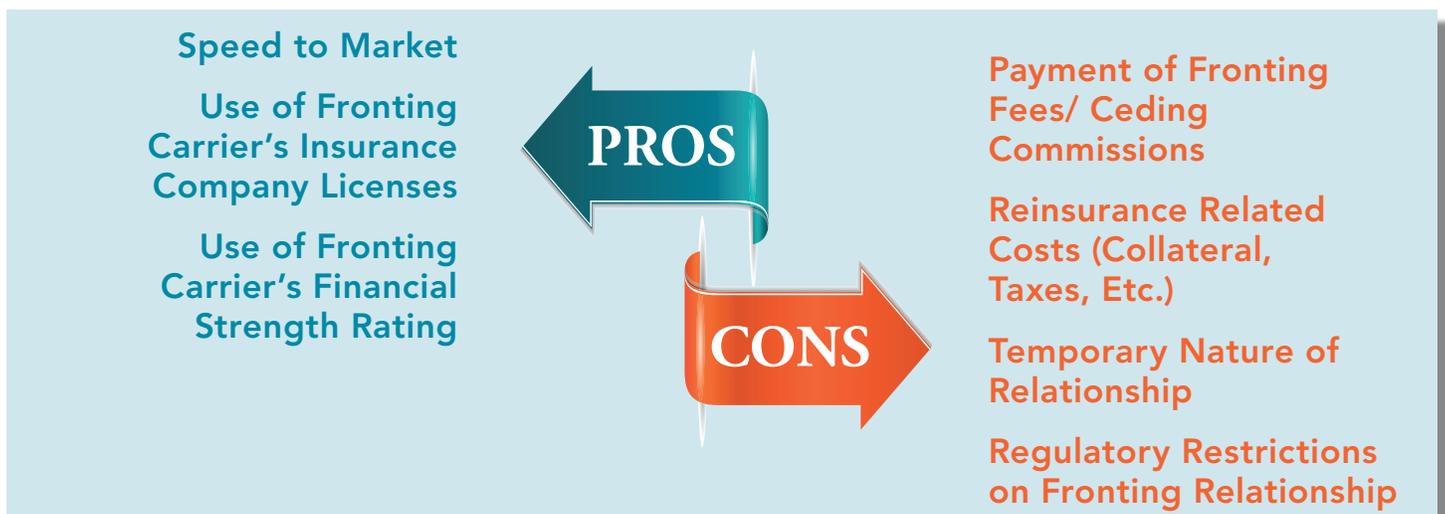
Generally, insurance carriers need a license from every state in which they want to do business. Obtaining such licenses requires substantial time, effort and capital (as discussed below). In addition, insurance carriers are financially rated, and many of the major rating agencies are hesitant to rate a brand new carrier that is not affiliated with an existing insurer or major financial institution.

Because of these hurdles, many MGA/TPAs utilize what is called a fronting relationship with an existing broadly licensed insurance carrier. The first step in any fronting relationship is the MGA / TPAs forming what is known as a Producer Owned Reinsurance Company, or PORC. Once nearly exclusively located in the Turks & Caicos (there are worse places to have to travel for business), PORCs are insurance companies owned by MGA / TPAs in order to reinsure the business they produce for a fully licensed carrier. Once the PORC is formed, the fully licensed insurance carrier will transfer all of the premiums (and risk) to the PORC via something called a 100% quota share reinsurance agreement. And presto, you basically have yourself a fully licensed and rating insurance carrier, with none of the hassle of buying or forming one yourself.



However, just like renting a house, a PORC will need to pay the fronting carrier a monthly/quarterly fee (called a ceding commission) for the privilege of "renting" the fronting carrier's licenses and financial strength ratings. In addition, because regulators shockingly logically, do not fully trust newly formed PORCs, in most cases the PORCs will need to post collateral (cash, letters of credit or trust account) to secure its obligations under the reinsurance agreement (think of this as putting up your first and last month's rent). Finally, continuing our already tortured analogy, like that landlord who can decide to terminate or jack your rent up at end of your lease period, there is often no guarantee from one year to the next that the terms of the agreement won't change.

Notwithstanding the above, given the cost and timing requirements related to buying or forming your own fully licensed and rated carrier, fronting provides a great way for InsurTechs to get their feet wet in this space.



Option 2: Buying a Shell – Buying An Existing (but empty, we hope) Home

If using a fronting arrangement is like renting a house, buying a shell insurance company is definitely the equivalent of buying an existing home and hoping the home inspector did his job and you didn't just buy a money pit.

In general, you cannot sell insurance company licenses as if they were assets. While this makes logical sense (given that they are issued to a specific company based on that company's financials, management and business plan), oftentimes an insurance company's licenses are by far what makes that company valuable. This often happens when the industry consolidates and an insurance holding company system ends up with more licensed companies than they need. This will lead the holding company to cause such extra insurance carriers to transfer all of their risk and administration to an affiliate through reinsurance and intercompany services agreements, and shutting down – leaving nothing but a "shell" of a company, with no ongoing operations, except its licenses intact.

Holding companies monetize these shells and their licenses by selling them to entities that want to hit the ground running when starting up their insurance carrier and are willing to pay for the privilege. Assuming the shells are fully cleaned out, and there are various mechanisms to do so, the purchase price can be as low as the minimum capital and surplus required by law to be held by the shell (\$2M – \$5M depending on state and lines of business) – think of this as land value – plus a fixed amount per state license (with more broadly licensed carriers and those licensed in populous states being the most expensive) – think of this as the value of improvements; a nice home is always going to cost more!

However, like any existing home, a shell company is usually never clean. At some point in time, it likely once had active operations, including employees, risks that it was directly responsible for, and real estate. As such, the most important aspect of any shell deal is conducting appropriate diligence to ensure that the entity selling the shell company truly has stripped it of any legacy liabilities and if not (which is almost always the case) negotiating some level of parental guaranty or appropriate indemnity for any remaining liability. Think of this as getting a home warranty as part of your home purchase. You never hope to use it, but you are sure happy it's there when your pipes burst during a Polar Vortex (or you find the corporate equivalent – such as unfunded employee benefit liabilities).



Also, because your purchase, and you as the purchaser, will be subject to an in depth regulatory approval process in the shell's domestic state (called a Form A approval), including a possible public hearing, and there is the potential that other states may pull or limit the shell's license authority due to the transaction, it is also key to ensure payment for the licenses is contingent on them being in good standing as fully transferred, just as you wouldn't pay for a broken window you discovered during a final walk through. Finally, unlike fronting, as new owner of the shell, you will be directly subject to the full panoply of regulations impacting carriers including maintaining sufficient capital and surplus beyond the minimums (e.g., risk based capital), holding company filings, annual statutory financial reporting requirements, etc.

**Speed to Market
(But Slower Than
Fronting Due to
Negotiation and
Regulatory Approval)**

**Ability to Potentially
Obtain Numerous
Licenses**

**Relatively Low
Initial Cost Up**



**Risk Associated with
Legacy Liabilities of Shell**

**Finding the Right Shell
that Meets your Licensing
Needs**

**Time and Expense of
Regulatory Approval**

**Ongoing Regulatory and
Capital Requirements**

Option 3: Forming a New Insurance Carrier – Building A New Home

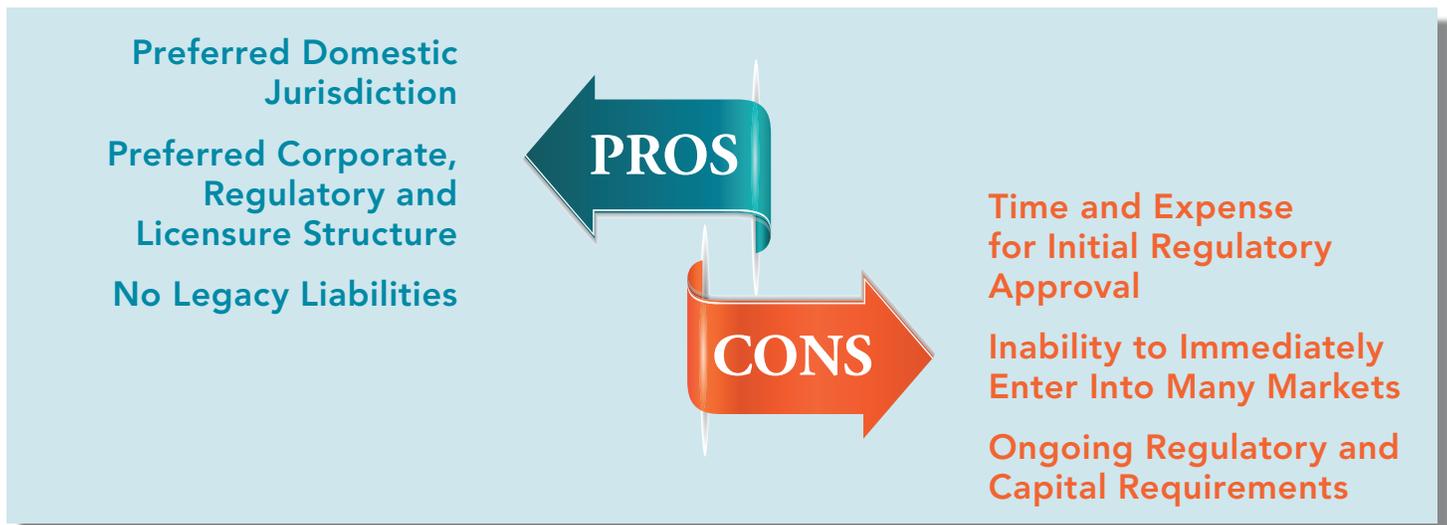
Take a long deep breath in ... nothing beats that fresh new insurance company smell. Everything is how you designed it, from your choice of where to domicile it, to the type of licenses you obtained, and let's not forget that great name and logo! Not only that, you don't need to worry about whether this one has any hidden skeletons in the closet. As with a new house, a new, clean insurance company is often the best choice if you have sufficient time and resources.

But there are downsides. First, there are regulatory approvals to obtain. This often involves a relatively heavy level of vetting of not only your current financials, but also projected financial pro formas, business plan and

management team. And obtaining such approval can take anywhere from three to six months, if not longer. And you thought getting a building permit was arduous! Next, once you obtain your license from your "domestic" state (called a "certificate of authority"), licenses must be obtained in all other states where you wish to conduct business. However, many other states may not issue you a license and allow you to write business in their state for a number of years, imposing what is colloquially known as "seasoning" requirements (think cast iron pan, not salt and pepper). While there are ways to address these requirements, for example utilizing a fronting relationship while your new carrier writes business



in the domestic state for the required period of time, seasoning requirements are often the biggest deterrent to mass scaling from a newly formed insurer. Finally, as with buying a shell insurance company, you will need to be in charge of all the things that go into running a carrier (RBC, statutory financial filings, holding company filings, etc.) But, in the end, there is nothing like your first new insurance company, right?!





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