

NICHE INSURANCE COMPANIES

STEWART ECONOMICS, INC.

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EXECUTIVE SUMMARY

This report is about niche companies in the personal property-casualty insurance market. The report introduces the niche idea and sets out case histories of several niche companies. Then the report draws conclusions about how and why such companies come into existence, about how they work and about how they affect the rest of the market.

A niche insurance company is created to help people in the niche. Often it is a self-help effort by the people themselves. But this report focuses on the broader impact of such companies – on what they do to and for the market in general. For niche companies lead the whole market to evolve and to renew itself. They are agents of change. They do it by breaking through the uniformity and rigidity that usually prevail in insurance markets. Their breakthrough forces change upon the others.

What prompts our analysis is a growing tendency of federal and state governments to address some current insurance issues by requiring uniformity in the way the business is done. Government may again command the uniformity that has, in the past, created the need for niche insurance companies.

The Niche Solution to Market Neglect

The forces of uniformity in insurance have always been strong, for valid business and regulatory reasons. Those forces have also tended to make the insurance market rigid and resistant to change. It has often happened that the uniform and unchanging market left out some people who wanted in. They were not able to get insurance at all, or not on terms they considered fair. Sometimes those people devised a solution. It followed a recognizable, recurring pattern.

Niche companies have appeared throughout the history of insurance in America. Among their customers were the members of auto clubs and farm bureaus, military officers, government employees, teachers, older people, wealthy people, non-drinkers and Japanese Americans. Their stories have a common thread. Niche companies were created when the established sellers of insurance would not or could not respond to the needs of a particular group of insurance buyers.

Every niche company began as a practical solution to a real problem of customer neglect. Many were self-help efforts. While neglect got them started, two other qualities kept them going. The report calls those qualities identity and access.

Identity was traceable to some characteristic the people in the niche had in common, often one that set them somewhat apart. The common characteristic made them recognizable as a distinct group. The characteristic was always something about them other than their need for insurance. It could be an occupation or a hobby or club membership or nationality or religion.

Identity fostered loyalty between the niche company and its customers, loyalty running both ways. Loyalty on the part of the company meant sustained focus on the niche. Focus led to expertise in underwriting, marketing and loss control. Loyalty on the part of customers meant they stuck with the company. Such stability lowers costs. When working well, these qualities reinforced each other in a virtuous circle.

A big item of expense and difficulty for any insurance company is distribution or access to the customer. Natural and easy access to niche members led to efficient distribution of insurance by the niche company. In the history of nearly every niche company, the founder was already connected with the neglected group. Doors were open, and sometimes the group formally endorsed or sponsored the new insurance company. In one way or another, the close relationship between the company and its customers simplified distribution and lowered costs.

The Niche Company as Agent of Change

When market uniformity and rigidity leave an unmet need and a niche company fills it at a profit, sooner or later that fact becomes known. Other companies, including the established ones whose neglect of the niche created the market opening, then want the niche clientele and start competing for it.

Insurance is a business with no meaningful patent, copyright or other special protection from competitive pursuit and emulation. Any innovator in the insurance marketplace can find the fruits of its creativity, effort and risk-taking appropriated by larger, better capitalized competitors. It may seem unfair, but in the real world of the insurance business, that is the way competition works.

But sometimes the niche innovator develops cost and service advantages that are too great for established providers to match. The unmatched advantages protect the innovator's niche position and give it a secure base from which to expand into the general market. At that point, the established companies find themselves on the defensive on their own turf. They have to improve their own operations just to hold onto the business they have.

In that way, the niche company breaks through uniformity and market rigidity, and it does more than simply survive as an exception. It makes the whole market take notice and adapt. It is a catalyst for change. That is due to the niche company characteristic of efficient access to customers. Efficient access means lower costs of distribution and of overhead in general. Lower costs mean lower prices. Challenged by that kind of competition, the established companies have a choice: get their own costs down or lose business.

Niche company formation is an essential step in the competitive process of creative destruction by which the insurance market evolves. Niche companies are not

the only forces for change in insurance, but in the history of the personal lines of property-casualty insurance, they have been the most important one. Today, over half of personal lines is written by companies with niche origins.

Public Policy and Niche Insurance Companies

The uniformity and rigidity addressed by niche insurance companies grew out of practical business and regulatory concerns. For most of the history of the insurance business, uniformity and rigidity were based on agreements among competing insurance companies. The agreements covered premiums, policy forms, agent compensation and underwriting criteria. Their purpose was to prevent insolvency. Until the end of the Second World War, such agreements were lawful in insurance, and they covered nearly all of the market. Even after explicit agreements became illegal, many of the old practices and attitudes lingered, both in the business and in its regulation.

Starting after the Second World War, the state regulators of insurance, prodded by anti-trust minded federal officials, loosened their support for uniform pricing and underwriting in the cartel style. Price competition began to look like a good idea. With growing regulatory tolerance and even encouragement, more efficient sellers of personal insurance took over larger shares of the market.

By the late 1960s and early 1970s, most state insurance commissioners and most of the industry had come to favor competition and the abolition of the kinds of rate regulation that restrained competition. It was a complete turnaround on the issue of competition versus uniformity for both the business and its regulators. With the emphasis on competition, companies sought out neglected market segments and other pockets of profit. Very few niche insurance companies came into being because the pre-conditions – chiefly neglect – did not exist.

The swing from government support for uniformity to government support for competition was a momentous change for insurance regulation. It was a full swing of the pendulum between two competing basic principles for insurance – rating everybody the same and rating each risk according to its propensity to cause loss. It was also a full pendulum swing between two competing principles for government’s role with respect to any regulated business – prescribing how the business is to be run and encouraging the market to work it out.

In both the general government-business dimension and in the specific regulation-insurance dimension, such swings in public policy cannot be expected to go on forever in one direction. None of the ideals involved is valid at all times and to the total exclusion of its opposite. The postwar movement toward competition in insurance indeed did not go on forever. It ended in the late 1970s, when people saw that competition did not solve all their problems with insurance rates – particularly the problems of regressiveness in auto liability insurance rates and of premium inflation generally.

Since then, while industry sentiment has continued to favor competition, government attitudes have swung somewhat away from competition, at least enough to make the enforcement of uniformity of pricing and underwriting once more a possibility. Government-enforced uniformity is offered with increasing frequency today as a remedy for various insurance ills, be they company insolvencies or rising premium rates or the desire for subsidization of one market segment by another. The pendulum of public policy has not moved as far against competition as it might, but unmistakably it has moved.

Prospects for the Niche Idea

Should the pendulum move much further, the stage would be set once again for the kind of uniformity and rigidity that eventually become oppressive and neglectful. Those are the conditions for which niche insurance companies are the historically proven response and corrective.

To the extent that measures are proposed today for forcibly leveling out the market, it is good to keep in mind the role of niche markets and the niche insurance companies that spring up to serve them. It is a role of significance not just for the people directly involved but for the dynamics, over time, of the market as a whole.

Given the push toward uniformity on the part of government and the natural hostility of established companies toward niche companies, there is a danger from time to time that the niche response will be suppressed. But buyer frustrations can work out in other ways. Niche companies with their self-help origins are analogous to risk management in commercial insurance, where buyers who object to uniform treatment opt out of the regulated market. Similar alternatives are not difficult to imagine for personal lines.

Niche companies arise as a natural reaction by the insurance market to certain excesses that the market is naturally prone to. Those are excesses of sameness, inefficiency and inattention to customer needs. Those excesses are all too familiar in regulated industries. The excesses have great staying power, for they can be permanently congenial to industry and government. Unless something shakes them up. In insurance, niche companies are what shakes them up. Niche companies prompt the whole insurance market to change. Usually the change is toward greater inclusiveness and greater efficiency. After the shakeup is over, such change usually turns out to be good for just about everybody.

INTRODUCTION

This report is about niche insurance companies in personal property-casualty insurance. This introduction explains some terms and outlines what is in the body of the report.

A "niche", in insurance as elsewhere, is a part or segment of the total market, usually a small part. It is a part with some coherence, some commonality within it. The members of the niche population can be described in terms of some characteristic, such as being farmers or members of an auto club.

The concept of an insurance niche is close to but different from that of an insurance specialty. "Specialty" is a familiar word in commercial property-casualty insurance and refers to new, unusual and often risky activities. A niche differs from a specialty mainly in that a niche is first identified by some common quality of its customers other than location, risk quality or coverage required. Both terms, however, are fuzzy around the edges and often overlap in insurance usage.

This report cites about thirty insurance companies which fall naturally into twelve kinds of niches in the personal property-casualty market. Some of the companies that created the niches are still in them. Others have broadened to serve the entire market. Some of the companies are small. Some are very large. Together they are far from just a curiosity, for companies with niche beginnings account for half the personal property-casualty market. They are interesting beyond their size, for what they tell us about insurance and the ways people deal with it.

The companies cited in this report and many others got started in response to two characteristics of the insurance business, its uniformity in the ways companies

operate and its rigidity or resistance to change. The uniformity and rigidity exist for entirely understandable reasons, as follows.

Treating customers largely the same makes business sense. It is convenient and it retards price competition. In the past, when information was more difficult and expensive to gather, process and communicate, treating people the same also saved a lot of money. Broad categories and uniform terms and prices were economical substitutes for information.

Charging the same to people with different likelihoods to cause loss is not, however, an arrangement that can withstand competition. Sooner or later some competitor charges a little less and makes off with the best risks. Insurance companies figured this out a long time ago, and they agreed among themselves to charge the same. Then they got government to enforce the agreement.

Price-fixing is illegal under the anti-trust laws in most of the American economy and it is illegal in insurance now, but until the end of the Second World War the anti-trust laws did not reach insurance and the agreements were entirely legal. Understanding how they worked is a key to understanding many things about insurance, even today.

For purposes of understanding niche insurance companies, three implications of legal price-fixing are important. One, the agreements cannot just be on price. To be meaningful they have to specify what the price is charged for and bind the parties not to change that. In the OPEC cartel that means a grade of crude oil. In insurance it means policy forms and underwriting criteria. Two, agreement is hard to get. The fact that companies are allowed to agree does not mean that they can do it, partly because, as competitors, they are apt not to like or trust each other. Being hard to secure, the agreements are hard to change. Three, legal price fixing is addictive.

Competitors that engage in it for long come to depend on it and to regard price competition as irresponsible behavior to be stamped out.

Accordingly, one result of its reliance on enforced uniformity was that the insurance industry became highly resistant to change. But the world changed around it. As the industry's prevailing attitudes toward accepting and pricing risks lost touch with changing needs and conditions, some people were not able to get insurance at all or on acceptable terms. Such market neglect encouraged new providers to try to meet the new needs.

Niche insurance companies arose when members of neglected groups got together to help themselves out of their shared difficulty. The members identified with each other, could be defined in terms of their identifying characteristic and, because they were already together for some other purpose, could be reached conveniently for purposes of selling and servicing insurance. Without getting too far ahead of the story, we note that niche companies have those three characteristics in common: market neglect, common identity and easy access.

The stories of niche insurance companies have never been told all together this way. That is understandable, for they are, by definition, highly individualistic endeavors. But it is useful to do so, for three reasons.

The first reason for studying niche insurance companies is that they have been the main agent of change in a business whose natural uniformity and rigidity would otherwise let it drift out of touch with changing public needs. The cooperative or self-help tradition is close to the origins of all kinds of insurance, and it keeps insurance responsive to the needs of the host society, despite natural tendencies the other way in any functioning insurance business. Niche insurance companies are the results of self-help in personal property-casualty insurance.

The second reason is that the direction of change brought about by niche insurance companies has been in favor of competition and efficiency, as new niche entrants have either taken market share by offering a better deal or have forced the established companies to change to fend them off. They have been the agency of creative destruction through which market competition works in insurance.

The third reason for studying niche companies and doing so now is that government today is trying to deal with some of the social problems of the insurance market – once again the market's tendency to neglect some customers – in ways that lead back to enforced uniformity.

Studying what actually happened is the best way to understand the significance of niche insurance companies. The next section of this report sets out some of their stories. Then the report draws some general conclusions about how they work, what they have contributed and what are and should be their prospects in the future.

PROFILES OF PAST AND PRESENT NICHES

This section sets out profiles of companies that began by serving only a limited market segment. They were selected because of their identifiable niche origins and because they are still around today, although some would not be considered niche companies anymore. The companies, the year they began and their present status are summarized in Appendix B.

Automobile Clubs

The first personal lines niche companies were reciprocal auto insurers started in the early decades of the twentieth century by automobile clubs.

Around the turn of the century, enthusiastic owners of the new horseless carriage formed automobile clubs, mainly in big cities. Auto owners then were a small group of people who could afford cars and used them mainly for Sunday drives and "touring". The clubs promoted road building and signage, made maps, held rallies, and later developed safety and driver education programs.

Insurers were wary of insuring cars and their owners. They did not know how to rate these new and unfamiliar risks, and many insurers believed liability insurance created a moral hazard. So the organizations that developed and administered the agreed, uniform rates for those companies – the "rating bureaus" – set the rates very high.

Obviously the enthusiasts in the auto clubs had a more favorable view of their hobby. Auto insurance was a logical service for the clubs to provide. Some clubs formed reciprocal exchanges to sell insurance to members "at cost", that is, without a profit loading. Expenses were kept down by using salaried employees rather than

commissioned independent agents. The reciprocal insurers were outside the rating bureaus and the requirement of uniform rates. They charged less, usually 25% to 30% lower than the bureaus. Low prices drew members to the clubs and customers for the new niche insurance companies. The competition even forced the bureau companies to reduce rates.

Six auto club insurance companies that were started in the early days survive today. The three largest and most successful are associated with the auto clubs of northern California, Michigan and southern California. They are respectively the 13th, 20th and 22nd largest private passenger auto insurers in the country. The two California clubs together wrote \$2.1 billion of direct auto premiums in California in 1995, which accounted for the second largest (17%) share of the state's private passenger auto insurance market. The Michigan auto club, with direct premiums of about \$1 billion had the largest share (23%) of that state's market in 1995.

Of the other descendants of the early auto club companies, the ones in Missouri and Pennsylvania (Keystone) are small but significant writers in their states. The Chicago club company has had financial problems and has limited its writings. Other early auto club insurers were merged into other club companies or disappeared. Some drifted into the general market and are no longer related to auto clubs. Three auto club insurers were formed more recently: one in 1946 in Ohio which writes in many states, one in 1962 in Iowa, and one in 1991 in Florida. None of those companies has a significant market share.

Auto club insurers now write other lines such as homeowners, inland marine, group accident and health and life. They also sell to AAA members in other states, typically through subsidiaries. They ceased being niche companies many years ago as their members became indistinguishable from the general population.

Farm Bureaus

The farm auto niche was the most successful of all. Companies that began there now account for \$46 billion or 35% of personal property-casualty premiums written in the United States. Farm niche companies that succeeded are important in two ways. First, they still dominate that niche. Second, several of them, such as State Farm and Nationwide, broadened their customer focus and became very important in the overall personal property-casualty market. The reasons why the established insurance companies left open a niche so big, and one so profitable, illustrate vividly the niche phenomenon.

Before the advent of the automobile, fire insurance accounted for 80% of total property-casualty premiums. Fire insurance was mainly a city coverage. Large property values accumulated there. City buildings were close together, so one could catch fire from another. Many early insurance companies had offices and agents only in the cities. Farmers did need some fire insurance, and rural mutual fire insurers sprang up to serve them. They were local self-help arrangements and not inclined to be aggressive or entrepreneurial. When automobiles came along and farmers bought them, the rural mutuals did not rush to meet the need for a new coverage.

During the 1920s and 1930s, as more and more farmers took up driving, their only source of automobile insurance was the local agents for the established insurance companies. Those companies were the large, urban, mainly fire insurance writers for which rural America was an afterthought. The auto insurance rates they charged everybody were the high, uniform, rating bureau rates, which were based on the accidents and claims of city drivers. But it is and was pretty obvious that rural claims experience had to be better. People in rural areas drove less, often not at all in bad weather, and country roads carried fewer cars to run into.

The opening for new insurers was vast. At the time, twenty-five percent of the nation's population lived on farms. Many farmers belonged to state farm bureaus or state granges, non-profit organizations established in the nineteenth century to help farmers improve their productivity and quality of life. The farm organizations became the organizing basis for new insurance companies, formed specifically to offer farmers a better deal.

A common pattern was to set up a general agency between the farm bureau or grange and a new insurance company. This pattern of operation was established by George Mecherle, who founded State Farm Mutual Automobile Insurance Company in Bloomington, Illinois in 1922. His general agency contracted with state farm bureaus to sell State Farm's insurance to their members. The policyholder paid a one-time membership fee plus a security deposit, so renewal premiums were lower than the total first-year charge. But the biggest incentive for policyholders to stick with the farm auto insurers was that premiums kept coming down. After a year in business, the Ohio farm company found it could make money with renewal premiums only one third of what the established companies were charging.

The early success of State Farm Mutual Automobile Insurance Company and Farm Bureau Mutual Automobile Insurance Company of Ohio (which became Nationwide) encouraged a number of state farm bureaus to set up their own automobile insurance companies. They typically accepted as policyholders only farm bureau members of their home state. Companies were formed in each state on the theory that farmers would have a closer tie and sense of ownership in a company that was local. Auto insurance became an important source of revenue for the farm bureaus and an inducement for new members to join.

Thereafter the farm bureau companies took two paths. The first was taken by such companies as State Farm and Nationwide, which early on decided to sell to the

general public. They also extended their operations beyond their home states, with an exclusive agency force no longer tied to the farm bureau. These two companies went on to become the first and fourth largest personal lines insurers in the United States and today represent 25% of the American personal lines market.

The second path was to stay with the farm population, often in a single state, and that has been successful too. The farm bureau companies that have stayed in the niche may individually be small relative to companies that write for the general population countrywide, but they have major market shares in their own states. For example, in Alabama, the Alfa Insurance Group, the second largest writer in that state with \$370 million of personal lines premiums in 1995, has a 21% market share. The Southern Farm Bureau Group (which includes farm bureau companies in the states of Arkansas, Florida, Louisiana, Mississippi, Missouri, South Carolina and Texas) alone wrote over \$1 billion of personal lines premiums in 1995, making it the twenty-third largest personal lines organization in the United States.

Together the farm bureau companies wrote \$3.7 billion of personal lines premiums in 1995. If they were counted as one consolidated group, they would be the sixth largest personal lines writer in the United States. Although these companies offer insurance only to members of their respective farm bureaus, applicants do not have to be farmers to be eligible for membership. For the most part, the farm bureau companies are profitable and in excellent financial condition.

For many years, the farm bureau companies sold only auto insurance. Fire insurance needs were adequately met by town and county mutuals, but the big problem for these local companies was reinsurance. Fire insurance had to be sold with the extended coverage endorsement, which covers storms. In the plains states, a windstorm could wipe out a company that wrote in only one state. In 1948, the American Farm Bureau Federation helped organize American Agricultural Insurance

Company for the purpose of spreading that risk through reinsurance. At about the same time, home fire insurance was superseded by broader homeowners coverage, which became important in short order. Expansion into homeowners insurance, as well as into life, gave the farm bureau insurance agents additional income and a full-time job and enabled the farm bureau companies to compete with the established companies in all aspects of personal insurance.

In the critical years of the 1920s and 1930s, as the automobile was spreading across the country and the farm bureau companies were insuring the rural drivers, the established, urban, fire insurance companies sat still. It was a classic example of being imprisoned by their own system. The rating bureau did not even establish a separate classification for farmers' cars until the 1940s. By then the rural market was taken, and as the suburbs extended into the countryside in the 1950s and 1960s, the companies with farm bureau origins were perfectly situated for them. From their niche origins they gained the best of competitive advantages – lower costs. The independent agency system used by the established companies was inherently more expensive than the exclusive agency system of the farm bureau companies. Using independent agents meant overlapping and dispersed functions for the companies and differing procedures and criteria for the agents. But no independent agency company could break out of that system and survive.

Military Officers

Armed Forces Insurance Exchange

The first insurance organization to serve military officers was the Army Co-Operative Fire Association, which was formed in 1887. During the Indian wars in the latter part of the 19th century, the Army set up small garrisons west of the Mississippi. Army officers and their families regularly moved from post to post. The

established east coast fire insurers were unwilling to protect possessions in frontier quarters built of wood, heated by stoves and subject to raids. Agents were unable or unwilling to follow the officers from post to post.

Army officers at Fort Leavenworth, Kansas set up a reciprocal insuring organization, the Army Co-Operative Fire Association. For many years, it wrote only fire insurance. After World War II, it expanded eligibility to all services and broadened coverage. In the 1960s homeowners and liability were offered. When the automobile was introduced, the Association insured cars for fire but not liability. It got out of the auto market entirely in the 1920s, shortly before USAA was established, and has recently got back in.

Eligible for the Association's insurance are active and retired commissioned officers and the three senior grades of non-commissioned officers of the Armed Forces, officers of the Public Health Service and National Oceanic and Atmospheric Administration, persons in the military academies, and unmarried widows of members. Half of the business today is for retired or former military officers.

The company has always offered low-cost insurance to its members. Dividends have run as high as 50% of premiums in the past. Marketing has been by mail and telephone. Direct written premiums in 1995 were \$57 million.

United Services Automobile Association

United Services Automobile Association was formed by Army officers stationed at Fort Sam Houston, Texas in 1922. The Army cooperative out of Fort Leavenworth had stopped offering insurance on cars. Agents had little interest in selling insurance to army officers who were constantly on the move. When the officers could get coverage, rates were high.

For its first two years, USAA insured cars for army officers without even being an insurance company. Although the Texas Insurance Department corrected that oversight, USAA did not become licensed in any other state because it sold by mail. Then in the 1940s several states passed financial responsibility laws which could only be satisfied by licensed insurance, and USAA became licensed nationwide. During the same period, USAA expanded abroad in order to make coverage available anywhere in the world.

Eligibility for membership in the association was initially restricted to active officers of the military services. In 1951, it was extended to inactive officers and in 1961, to widows of members. While writing auto only for its first decades, USAA broadened to offer fire insurance, then liability, homeowners and life.

USAA's rates were always lower than the general market. In 1928 a simplified rating plan was adopted which set rates at 80% of the industry standard (except in Texas where the difference was returned as dividends). Its expense ratio today, at 13%, is below that of exclusive agency companies and a full seventeen percentage points below the typical independent agency company. It has been possible because loss experience has been better and expenses far lower (usually at least 50% less) than industry averages. USAA has never used agents but has sold from the home office by mail or phone. Total personal lines premiums in 1995 were \$4.4 billion, making USAA the fifth largest personal property-casualty insurance organization in the country.

Government Employees

GEICO

Government Employees Insurance Company was founded in 1936 by Leo Goodwin. He had worked for USAA for ten years and was Chief of Underwriting

and Accounting as well as Office Manager when he left to start his own company. Goodwin maintained a friendly relationship with USAA, and he clearly borrowed from its experience.

His idea was to sell insurance directly, like USAA, and by eliminating commissions to agents, to charge 25-30% less than the standard bureau rate. The company would sell to preferred risks, whom he thought he would find among civilian government employees. While Government Employees Insurance Company was formed in San Antonio, Goodwin soon moved the company to Washington, DC to be closer to its target market.

Growth of the company was rapid from the start, and it took off with the expansion of federal agencies after World War II. Until the mid-1970s its growth rate in auto insurance was more than double the industry's. GEICO's expense ratio, which had been low to begin with, dropped to below 15%, and the combined ratio averaged 85% until 1967, when it moved into the 90s.

Eligibility was opened up over the years. After the war, it was extended to military officers, including veterans. In the late 1950s, it was extended to other occupational groups which were believed to include many preferred risks, namely, educators, managers, professionals and administrators. In 1962 agricultural and clerical occupations were added, and in 1973 all occupational standards were discontinued.

Then, in 1975, GEICO got in deep financial trouble and nearly became insolvent. GEICO had continued to grow rapidly in the face of worsening fundamentals. States had mandated rate reductions with the introduction of no-fault laws, and in the early 1970s, inflation erupted with the energy crisis and the removal of federal price controls. The company's loss reserves were grossly underestimated. Because GEICO was highly leveraged – in 1974 premiums were five times surplus –

it did not have enough capital to cover the losses. GEICO was rescued by an industry reinsurance deal and an infusion of capital, which gave it time to increase its rates, reunderwrite the book of business and tighten its operations.

GEICO had other disappointing experiences when it departed from Leo Goodwin's original idea. In the early 1980s, it made an unsuccessful foray into the reinsurance business, a venture that was put into runoff in 1987. In 1991, GEICO bought and then sold two years later a property-casualty company that sold through independent agents.

GEICO ceased being a niche insurer early when it widened its focus to preferred automobile risks regardless of government employment. In 1987, it returned to the original niche by restricting new business of the lead company, Government Employees Insurance Company, to government employees and military personnel. Other GEICO companies sell to persons in other occupations and to those who are below the preferred rate standards. GEICO today is the sixth largest auto insurer in the U.S. Its total personal lines premiums in 1995 were about \$2.8 billion.

Civil Service Employees Insurance Company

Civil Service Employees Insurance Company was founded in 1949 in San Francisco. It was formed to provide automobile insurance to state and city employees at cheaper rates, which were initially at discounts up to 35% off standard.

Although Civil Service Employees' target market was primarily policemen and firemen, the company would write anyone who was technically a civil servant. Teachers were not attracted to the company because they did not consider themselves civil servants, and there were other niche companies marketing specifically to them. Many of the company's independent agents were retired civil servants. Prospects

were approached through credit unions. The first general manager had been a civil servant, an examiner with the California Insurance Department.

The company's growth in the first ten years was rapid, but began to stall in the 1960s. In 1961, the company began writing preferred risks who were not civil service employees. It expanded its operations to several other western states and to other lines including homeowners and some commercial coverages. In 1985, the non-civil servant book of business was put into a separate subsidiary. It had become about half of the company's premiums.

Civil Service Employees today is a medium sized (\$114 million of direct premiums in 1995), personal lines (80% of premiums), California (89% of premiums) company, which considers itself a preferred risk company rather than a niche writer. It was purchased by a French mutual insurer in 1981.

Teachers

Agricultural Workers Mutual Auto Insurance Company

Agricultural Workers Mutual Auto Insurance Company was founded in 1948 in Texas by teachers of farming subjects and others in agricultural professions, such as county extension agents and U.S. Department of Agriculture employees. The founders believed they were better than average auto insurance risks and should not have to pay rates that were being charged everyone else, and they were right.

From the very beginning, underwriting results were very profitable, and in recent years, the company has returned about 30% of premiums to policyholders in the form of dividends.

Agricultural Workers Mutual has remained a small, niche company. It continues to restrict eligibility to Texas agricultural professionals, who are defined as persons with an agricultural degree or board designation.

The company has no agents. It markets only at agricultural conventions. Most business comes in by referral. About ten years ago, the company considered writing homeowners insurance, but decided against it. A life insurance company was formed in 1983, but it writes very little business. In 1995 Agricultural Workers Mutual had direct written premiums of \$27 million and surplus of \$12 million.

Horace Mann Educators Corporation

Horace Mann was founded in 1945 by two teachers associated with a credit union in Springfield, Illinois, who wanted to sell auto insurance to education association members. The initial surplus was contributed by educational associations in Illinois, Iowa, Arkansas, Minnesota and Missouri and by individual members of those associations. In 1949 they formed a companion life insurance company.

The original mutual company sold to teachers and schools and a few members of credit unions. It employed exclusive agents, many of whom were school teachers. Auto insurance was priced below standard rates. Initially more than half of the business was accident and health insurance, but starting in the late 1950s, the company's auto business grew rapidly.

Perhaps because Horace Mann's earnings could not generate enough capital to support its growth, the mutual sold Horace Mann Educators Corporation, the management company, to the Insurance Company of North America (INA). Several years later, the book of business written by the mutual was absorbed by an affiliated stock company, also called Horace Mann, and the mutual was liquidated in 1976.

Also brought into the Horace Mann group through INA ownership was Teachers Insurance Company, a California insurer that sold only to teachers and their families. It was formed with the sponsorship of the California Teachers Association, Southern Section, in 1957, as a reciprocal. The board members of the insurance company and the teachers association were the same. The INA connection ended in 1989, when management bought the companies in a leveraged buyout.

In 1967, when Horace Mann formed the stock company which became the successor to the mutual, it tried selling outside the educator niche. The stock company had, in addition to an "educational division", a "standard division", which sold homeowners and other property coverages through agencies connected with financial institutions. That division was shut down in 1980, and Horace Mann resumed its focus on the educator market.

The business of Horace Mann today continues to be personal lines of property-casualty and life insurance, annuities and group life and health insurance products for teachers and other employees of suburban and rural schools. Many of Horace Mann's exclusive agents are retired teachers. More than half of the business is property-casualty, and most of that is auto. The rest is homeowners and a small amount of educator professional liability. Direct property-casualty premiums in 1995 were almost \$400 million.

Many of Horace Mann's products are sponsored by the National Education Association (NEA) and various state or local associations affiliated with the NEA. Horace Mann insures 10% of school district employees in the United States.

Michigan Educational Employees Mutual Insurance Company

Michigan Educational Employees Mutual (MEEMIC) was started in 1950 by a group of teachers who believed that teachers were being charged too much for

automobile insurance. Their company was able to pay dividends to policyholders at the rate of 10% starting in 1955, and when it began to file its own rates in the 1960s, they were lower than the competition. Today, MEEMIC has among the lowest prices of all auto insurers in Michigan.

Since its founding, the company has sold only to school employees and their immediate families in the state of Michigan. The agents have always been teachers or other educational professionals. They have been exclusively employed by a general agency that was formed at the same time as the mutual and which for many years managed it. The mutual offered only automobile insurance until 1992 when it began selling homeowners. Before that, the agency had arranged to sell another company's homeowners coverage so that it would not lose auto policyholders to competing companies that offered both coverages.

MEEMIC has had consistently better growth and profits than the industry's. Today it is the ninth largest auto insurer in the state of Michigan, with six times more auto premiums than Horace Mann writes in the state. Total auto and homeowners premiums in 1995 were about \$100 million.

PEMCO

Pemco Mutual Insurance Company began as Public Employees Mutual Insurance Company. It was founded in Seattle in 1949 by Robert Handy, a former high school teacher. In 1936, he had started a credit union for teachers. Much of their borrowing was to finance the purchase of automobiles. Originally the credit union arranged with a general agent to supply the necessary insurance, but after observing that the members' loss experience could justify lower premiums, Mr. Handy set up PEMCO as the credit union's own company. In the 1950s, rates were deviated 25% to 35% off standard.

The company grew rapidly. It benefited from the early endorsement, in 1952, of the Washington Education Association. PEMCO accepted business from the general public as well as school employees. In 1972, when the company was writing about \$20 million of premiums, it split off the auto business for school employees into a subsidiary, PEMCO Insurance Company, and put homeowners, other lines and all risks written for the general public into the mutual.

In 1995, the school employee company wrote \$55 million of direct premiums, and the mutual wrote \$181 million. Both companies write only in the state of Washington. Together they make up the fifth largest private passenger automobile insurer in the state. PEMCO sells through independent agents and directly from the home office at the same rates. Its agents are encouraged to use the home office for servicing. Rates are low, with a discount available for school employees.

Older People

Colonial Penn was the first company to market specifically to older people. Insurers believed older persons were bad risks; for Colonial Penn they became a profitable niche. It happened because of the American Association of Retired Persons.

Colonial Penn was founded in the 1950s by Leonard Davis, an insurance agent who had put together the first group health insurance program for the New York State Retired Teachers Association and later, with the help of Dr. Ethel Percy Andrus, a similar program for the National Retired Teachers Association. Dr. Andrus was a retired school principal who was active in promoting the rights of the elderly. In 1958, she founded the American Association of Retired Persons (AARP) for people aged 55 and over. A guaranteed-issue group health insurance program for its members was set up through predecessor companies of Colonial Penn. Leonard

Davis put up the money to publish the first issue of the association's magazine, *Modern Maturity*.

In 1963, Colonial Penn began selling life insurance to people over age 50. Other companies saw them as unlikely prospects or simply uninsurable. Colonial Penn was able to offer a guaranteed-issue policy to all who applied by selling only small face amounts and then limiting benefits in the first two years.

Colonial Penn got into the auto insurance business a few years later when AARP began to receive complaints from members who found themselves automatically nonrenewed at age 55. Many auto insurance companies believed that as people got older they became worse risks. Colonial Penn's experience was that they got better. As people grew older, they drove more cautiously and took better care of their cars. Retired people drove less than younger, fully employed people did, and they did not drive during the congested commuting hours. Their children were usually grown up and no longer included in the family policy.

When Colonial Penn began offering homeowners and renters insurance in 1973, it found again that its over-55 market tended to be lower risk. Older people were home more of the time and took better care of their property than younger people.

When Colonial Penn's underwriting experience became known to the rest of the industry, older people became a sought-after, preferred class of business. Colonial Penn had an advantage, however, at least for a while. AARP's sponsorship helped draw in the target customers and made direct response marketing possible. The resulting low expenses, combined with the good loss experience, kept rates low.

Tension between the sponsor and the company over who controlled the relationship led to an acrimonious and highly public break. In 1979, AARP withdrew

its sponsorship. Although Colonial Penn retained many of its older policyholders, it sought growth in other markets, often by developing programs for affinity groups and reaching them by direct response marketing. Some of this new business turned out to be very unprofitable, particularly programs managed by general agents and backed by shaky reinsurance. The company would not have survived without capital from its new owner, Florida Power and Light. In 1991, Colonial Penn was sold to another company, which has cut back writings and has focused marketing once again on older drivers, now defined as “mature” and over age 40. In 1995, Colonial Penn’s direct premiums were \$530 million, down from a high of \$690 million in 1990.

Other Niches

Non-Standard Auto Risks

The Progressive Insurance Company was initially a small, regional insurer that wrote standard automobile risks. It began in Cleveland in 1937 as the Progressive Mutual Insurance Company.

In the 1950s, independent agency companies realized they were losing a lot of preferred auto insurance risks to low cost direct writers such as State Farm and Allstate. They responded by developing a very refined and complex rating plan which attempted to match rates more closely with the risks. Agency companies then became very selective. They sought the preferred classes under the new classification plan and rejected the rest. That meant many drivers with average or below average records were suddenly cut loose by the agency insurers. Agents had to find a market for these nonrenewed risks, and many pleaded to Progressive for help. Progressive concluded that much of the business could be written at a profit even though it did not fall in the preferred category.

In 1956, Progressive Casualty Insurance Company was formed to provide insurance at non-standard rates. By writing only the risks that other companies would reject, it became expert at underwriting and pricing the business. Progressive formed additional specialty companies in the 1970s and 1980s to support new non-standard activities. The mutual cut back writings to a small book of standard risks in northeastern Ohio. It was converted to a stock company in 1991.

The Progressive group has been one of the fastest growing and most profitable insurance organizations in the U.S. Today it consists of sixteen companies, two of them life. With personal lines premiums of \$2.6 billion in 1995, Progressive is the seventh largest personal lines and private passenger automobile insurer in the country.

Progressive has not been a niche company for some time. Today there are over a hundred non-standard companies in the market, many of which are subsidiaries of large carriers. Progressive itself plans to grow in the standard market.

Wealthy People

Most niche companies began with their niche. The Chubb story is one of turning a division of a multi-line company into a niche writer. Insurance companies managed by Chubb & Son had written personal property-casualty lines for many years. In the mid-1970s, after a decade of poor personal lines results due to high expenses, Chubb decided that it would have to do something other than compete on price with the lower cost direct writers. One market segment the direct writers did not emphasize was the wealthy.

Most companies were reluctant to insure wealthy people. They were uneasy about the concentrations of value in expensive homes, did not like to insure exotic cars and believed jewelry and fine arts insurance led to moral hazard. Chubb learned

that the experience on high value homes was good and that the premiums justified facultative reinsurance where values were too large to keep net. Jewelry and fine arts coverage had always been a profitable specialty, mainly because Chubb's agents had been careful about the risks submitted. Auto could be priced to cover the company's higher costs, as the company was willing to see that line taken elsewhere.

Chubb had cultivated for commercial business an agency force that included the large national brokers and many of the larger, regional agencies. Those agents had access to the personal business of owners and officers of their commercial clients, many of whom were wealthy people. They became more aggressive solicitors of this business after they learned the premiums often exceeded those for small commercial accounts.

Chubb's personal lines premiums in 1995 were \$850 million. It ranks as the 29th largest personal lines insurer in the U.S. Chubb's focus on high value homes has resulted in a personal lines book of which less than a quarter of the premiums are private passenger automobile. By contrast, automobile accounts for more than three quarters of the industry's mix of personal lines premiums. The profitability of Chubb's personal lines book has been consistently better than the industry's.

Mobile Homes

Foremost is the largest insurer of mobile homes. It was founded in 1952 in Grand Rapids, Michigan by a banker involved in financing what were then called "house trailers". Because he was having difficulty in getting the necessary insurance, he and some other investors set up their own company. At that time, all American house trailers were manufactured within 150 miles of Grand Rapids. The business boomed in the housing shortage after World War II, as trailers became one way to supply housing to returning GIs. Foremost did much to promote the house trailer

business. It brought together manufacturers, dealers, park owners and buyers. It set up dealer organizations, trained dealers and got them licensed as insurance agents.

Foremost expanded into recreational vehicles, snowmobiles, campers, motorcycles and boats. Growth was rapid. Then, in late 1960s and early 1970s, the company got into other lines of business, such as medical malpractice and liquor liability. When results turned bad in the mid 1970s – the combined ratio averaged 150 for two years – it stopped writing those other lines. In the 1980s it lost money again on financial guarantees of mobile home payments and on extended warranties. Today the company is out of those markets and is concentrating on what it calls its core business of mobile homes, travel trailers and motor homes. Foremost also has AARP's endorsement for mobile homes, business which is serviced by direct response.

Foremost has been very profitable in recent years. Direct premiums were \$425 million in 1995. It is the 23rd largest private passenger physical damage insurer (86% of the book) and 47th largest private passenger auto insurer.

Insuring mobile homes has now become widespread enough that it would no longer qualify as a niche. Other companies specialize in many of the coverages that Foremost offers.

Japanese Americans

Western Pioneer Insurance Company was founded in 1948 in San Francisco by Japanese Americans. After World War II, Japanese Americans coming out of internment camps could not get agents to sell them insurance. So they set up their own company and appointed Japanese American agents. The president was the only non-Japanese director. The company secured reinsurance through the Saskatchewan Government Insurance Office of Regina.

Although premium volume grew from startup to \$2 million by 1960, it was basically flat for the next ten years. In the early 1970s, the company decided to grow, but believed that in order to do so it had to sell outside the Japanese American community. So it began appointing non-Japanese agents. Today, out of 180 agents, less than a third are Japanese Americans. The remaining Japanese American agencies are descendants of the original ones. Most of the others were too small to survive. The stock of the company, which originally had been widely held by a number of Japanese Americans, had been consolidated by the mid-1980s in the hands of only a few. They sold out to a plastics company, which in 1995 sold the company to a Massachusetts insurance organization.

Western Pioneer has written only automobile insurance in the state of California. It has used bureau rates, and commissions have been high. Underwriting results on average have never been better than breakeven. The company today characterizes itself as a preferred risk writer. Direct premiums in 1995 were \$27 million.

Non-Drinkers

Preferred Risk Mutual Insurance Company was formed in Des Moines in 1947 by William Plymat. He had been involved in the temperance movement since he was a high school student. When working as a claims attorney for an insurance company, he became interested in the correlation between auto accidents and drinking. He reasoned that a company that insured only abstainers would have fewer losses and could charge lower premiums. He tested whether enough abstainers would buy insurance from such a company by surveying the radio audience of a Texas radio evangelist, who later became involved with the company.

Preferred Risk insured only total abstainers. It had low rates and a merit dividend plan, which was replaced later with a merit rating plan with surcharges for

accidents. The company grew rapidly and was profitable. It added a life insurance company for abstainers in the late 1950s and expanded the auto company's writings to property and homeowners coverages.

Most of the company's policyholders were religious fundamentalists, and many of the company's agents came from such denominations. The religious connections led to commercial insurance for churches and later for other non-profit institutions. Today more than half of the \$320 million of direct premiums written by Preferred Risk and its subsidiaries is made up of such commercial risks.

Preferred Risk also developed another successful but completely unrelated niche. One of the founding directors of Preferred Risk could not get insurance on his motorcycle, so in 1956 he and Preferred Risk management started a company, Midwest Mutual, to insure motorcycles. It sold to drinkers as well as non-drinkers. Today that company and its subsidiary also write mobile homes, recreational vehicles and other non-standard auto. Midwest Mutual markets through dealerships and affinity groups and with completely different agents than those of Preferred Risk. Midwest Mutual and Preferred Risk share operating facilities and have common directors. Midwest Mutual Group had direct written premiums of \$158 million in 1995.

Credit Union Members

Although PEMCO succeeded in building on a teachers credit union and Horace Mann and Civil Service Employees had early connections with credit unions, their successes appear to have derived more from the occupational niches that they served. The record for two pure credit union niche companies is mixed.

Members Mutual Insurance Company, which was formed in 1952, successfully sold auto and homeowners insurance to Texas credit union members until

1975. The company had big losses that year and after that was never profitable on underwriting. The problem may have been unusually rapid growth from 1976 through 1982. In 1991, Members Mutual and its subsidiaries stopped writing and were placed in conservatorship.

The credit union national association life insurance company, CUNA Mutual, owns two property-casualty companies. It formed CUMIS Insurance Society in 1960 and purchased League General from the Michigan Credit Union League in 1983. CUMIS Insurance Society writes primarily commercial coverages for credit unions and a small amount of personal lines coverages for credit union members. League General writes only automobile coverages for credit union members. In 1995, the personal lines premiums of the two companies were \$84 million. This book of business has been unprofitable most of the time.

CHARACTERISTICS OF INSURANCE NICHES

Three Recurring Niche Qualities

Even though the niche insurance companies profiled here developed differently, each in its own way started off with three qualities. The three were qualities of the niche the company addressed and of the company's relation to it. The three were not absolutely necessary conditions for a niche company to form, nor were they sufficient for success. But they recur over and over. The three are neglect of the niche by the market, shared identity of and among the people within the niche, and efficient access by the company to those people. For short, we call the three neglect, identity and access.

The first characteristic, neglect, is what causes a niche company to be created. Rigidity and uniformity in the conduct of the insurance business cause some buyers to be left out of the market or to be treated in ways they do not consider fair. The purpose of the niche company is to fulfill the unmet need.

The second characteristic, identity, is what the customers of a niche company have in common, that is, what causes them to identify with one another and to be identifiable as a group. That common characteristic is something other than being a disappointed insurance buyer. It is the same notion of non-insurance affinity that lies behind the "fictitious group" rules in health insurance.

The third characteristic, access, follows from the first two. Every niche company profiled here was founded by a person who was close to, and often a member of, the neglected group. The company knew where and how to find its intended customers. That often meant access could be gained without paying an

agent a commission. The company's access may even have been unique, as happens when a group sponsors an insurer.

Separating the three qualities is handy for analysis and exposition. But in practice, as illustrated by the companies profiled here, the three do not stand alone. The niche company appears in response to market neglect of an identifiable population segment which may already have grouped together for some other purpose, such as work or leisure activity. The grouping makes it easier to reach them with insurance. Neglect, identity and access are analytically separate, but in real world cases they are more likely to be intertwined and interdependent.

Neglect of the Niche

No business knows all its costs in advance, but insurance companies have to use forecasts and estimates to an uncommon extent. The biggest element of cost, future claims or losses, has to be a forecast. The forecast is based on large bodies of statistics reflecting past experience. For that reason alone, and there are others, price competition in insurance can be unusually fierce and debilitating, for no competitor knows for sure that the last price cut, or the next, is unjustified.

For as long as there has been insurance in this country, insurance companies have worked together to try to reduce that uncertainty about costs and to mitigate the harshness of price competition. The most direct way is to lump all their statistical experience together, for that makes it more reliable, and then for them to agree to charge whatever price the statistics indicate is appropriate.

Competitors making rates in concert, agreeing to adhere to them and forbidding any company to deviate from them sound blatantly illegal. That is because our ears are tuned to anti-trust principles. The history in insurance is more complex. Insurance companies receive people's premiums long before paying their claims, so

people depend on the companies' staying able to pay claims during the interval. That gives government a proper interest in the financial health of insurance companies that it does not have for general business corporations.

Based on that interest in insurer solvency, many states supported industry agreements on prices and the attendant enforcement machinery. In effect, for much of its history in most states, the property-casualty insurance business operated a perfectly legal, highly effective cartel. The Supreme Court had held years before that insurance was beyond the legislative reach of Congress, so the passage of national anti-trust laws starting in the 1880s did not affect insurance.

The problem with such arrangements has been making them stick, since any company can gain by being the only one to cheat. The key is whether government helps or hinders the effort. Cartels need enforcement and enforced uniformity across an entire industry is by its nature rigid over time. This combination of uniformity and rigidity makes the market ultimately unresponsive to changing needs of the population.

During the cartel years, the agreed rates tended to be broad and general. Underwriting rules were uniform as well. This was far from all bad, and it was consistent with the fact that gathering information about individual risks, whether they were buildings or workers or drivers, was vastly more inconvenient and expensive than it is now.

One effect of so broad a uniformity so well enforced was that some people were unable to get insurance at all and many more were charged rates quite out of line with their propensity to cause losses. That set the stage for someone to overcome the established sellers' neglect of those customers. Coming in the late 19th century, it was the first major episode of the creation of niche insurance companies.

That episode, which concerned fire insurance for commercial buyers, is instructive although it is outside the focus of this report on personal lines. In that instance, self-help efforts by owners of industrial and mercantile buildings led to the creation of insurance companies dedicated to a single industry, such as printing or brewing or retailing. Most were organized in the mutual or reciprocal legal form, which seemed to fit self-help cooperatives. States usually did not impose high minimum capital requirements on those corporate forms and some imposed none at all. More important, the mutual and reciprocal forms allowed the reduction of premiums after the policy year was ended by the return of premiums called “policyholder dividends” or “subscriber savings”. Dividends and savings returned to policyholders were not controlled by industry cartels, nor were they regulated by the states.

When workers compensation laws were passed after 1910, many industries, now required to insure, found insurance companies unwilling to reflect their workplace safety efforts in lower prices. Again they turned to self-help, forming mutual and reciprocal companies. Again the insured activities were commercial, but the response set the pattern for personal lines niches shortly thereafter.

Self-help by those neglected was the pattern when auto insurance became an important personal line. Cars were rated by horsepower and use, with little geographic differentiation. When big city auto rates were charged to farmers, they were so far higher than the farmers’ risk of loss as to amount to market neglect. They called forth the first wave of personal niche insurance companies. At the introduction of auto insurance in the teens and twenties, another significant pocket of neglect was the hobbyist in the auto club, who tackled bad insurance rather as he did bad roads, as an obstacle to driving which had to be fixed.

In that first wave of personal niche company formations, some of the precipitating neglect was traceable not to the rigidities of rating but to those of distribution. Insurance agencies were local, and state laws impeded serving out-of-state business. For army officers who moved from post to post, that was a form of neglect met with two niche companies profiled in this report.

The second episode of market neglect which called forth numerous personal lines niche companies was right after World War II. Gasoline rationing ended; soldiers went back to work and commuted by car; a moratorium on liability suits was removed; financial responsibility laws spread; and prices of everything went up in the post-war inflation. Losses went up, followed by the broadly uniform rates. Established companies worried about the losses when rates were low and about capital to support premiums when rates were higher. They pulled back. Rates went up even more, and many people could not get the insurance they needed for the cars which were no longer hobbies but necessities.

Into the gap of market neglect came entrepreneurs who saw groups of people they believed were overcharged. The target policyholders included public school teachers, members of credit unions, employees of local government and persons whose religious beliefs made them perhaps better risks.

The same postwar conditions that caused the leading auto insurers to recoil from the market also affected the niche companies formed in the 1920s during the earlier wave, such as the farm and auto club insurers. But they had stayed independent of the bureau price-fixing system and were closer to their customers. By not cutting back when the establishment did, they rapidly increased their share of the total market.

During this same, immediate postwar period, most of the states began to loosen the bureau price-fixing system, and with it the uniformity of rate and

underwriting that had held for decades. Government was changing sides in the long running public policy debate between uniformity and competition. The bureau companies that stuck by the old system were now vulnerable to explicit price competition. To meet price competition from companies with an advantage in overhead and sales expense, the bureau companies tried to recoup on the loss side. They carried the breakdown of rate uniformity to great lengths, refining the bureau rating classifications so far that suddenly there were hundreds of classes and thousands of possible rates. Underwriting rules became correspondingly picky and severe.

When the bureaus fought back by refining their rating and underwriting so far and so abruptly, they cut off the insurance of many people. It amounted to the third episode of market neglect in personal insurance, a "substandard" market with a lot of people in it who, shortly before, had been insured dependably and at low prices. Again many niche companies sprang up. Many failed after a few years, for the downgrading of the neglected risks was not wholly fanciful. But from this episode emerged Progressive, which wrote many non-renewed risks, and Colonial Penn, which created a niche for older people who had been reclassified as undesirable.

In recent years, increasing competition in personal lines has lessened the market uniformity and rigidity which lead to market neglect which leads, in turn, to niche company formation. The most recent effort of any size was Chubb's concentration on the affluent almost 20 years ago.

Identity within the Niche

Founders of niche companies are usually part of, or at least close to, the niche population. That makes it easier to see the market neglect that triggers the process of

wondering whether it can be done better. It is easier yet if the population is already thought of as a group, that is, if it is already assembled for some other purpose.

The "fictitious group" and "group definition" laws that limit group health underwriting require a non-insurance reason for treating the individual members together. Such concepts have been applied to property-casualty as well but usually with the undisclosed intent of stopping group underwriting entirely. Whatever their purpose, laws requiring non-insurance affinity do have the effect of focusing attention on a valuable attribute for groups and niches. Common identity or affinity outside insurance makes everything more natural and hence success more likely.

The identification with each other and with the group is often based on membership in an organization, such as an auto club, a farm bureau, an educational association, a credit union or a church. It can come from shared occupational experience, such as military officers frequently posted far away, or a nationality experience, as with the Japanese Americans coming out of the internment camps after World War II.

Without straining the concept too much, we can see niche behavior in unexpected places. Occasionally the requisite identity is not lasting but transitory, as in the late 1950s when a large number of people were headed for the assigned risk plans for the first time, thrown there by the industry's sudden imposition of strict and overly sweeping underwriting requirements. The members of that group, brought together in the unfamiliar situation of being rejected by the same insurers who had previously welcomed them, were briefly a locational and age-related niche. Progressive re-created itself as their niche insurance company, and it has never been overtaken in the non-standard market. Or the requisite neglect may not have been apparent to its victims until the insurer pointed it out, as Chubb did with its affluent clients.

Sometimes the tie is a symbiotic relationship between two organizations. The farm bureau and auto club insurers found the sponsoring organization a vital source of insurance customers, and for their part the sponsors needed the commission and fee income from the insurance sales. Public employee and professional unions and associations have long used health and disability insurance as a membership benefit and a source of organization revenue and have long sought ways to add property-casualty, although without success.

Sponsorship is often important to niche companies, but it contains seeds of instability in the question of who needs whom more. The breaking point may be the change from the partners' seeing the insurance as a membership draw for the sponsor to their seeing it as patronage bestowed by the sponsor upon whatever insurance company it chooses. At that point, whatever unusual margins exist in the book of business because of the relationship are apt to migrate quickly and contentiously from the insurer's profits to the sponsor's fees and commissions. Colonial Penn could not hold onto the AARP sponsorship once AARP wanted to demonstrate it controlled what it had come to regard as its own account. State Farm lost farm bureau sponsorship early in conflicts over George Mecherle's managing general agency.

Identification runs both ways. So does loyalty, from members to insurer and insurer to members. The value of customer loyalty is rather obvious, but loyalty running the other way may be even more important. Loyalty from the company to the niche customers means that the company is unlikely to react to one year's bad results by mass cancellation or sharp uprating, as general market insurers are wont to do. It may be from the heart, or it may be because the niche company has nowhere else to go. But it pays off in the long run.

Often the loyalty from niche company to niche customer relates to the single-purpose ways of distribution that niche insurers have tended to use. Not only are they

usually less expensive than independent middlemen, but their very dependence limits what the company can do to its policyholders even if it wants to. When auto insurance losses and rates shot up after World War II, niche companies were as frightened as the rest, but they could not tell their exclusive agents and field employees to find another insurer. So they hung on and wrote more. That was when they consolidated their hold on the best part of the personal insurance market.

The few occasions when niche companies have acted differently and have weeded out business wholesale have been efforts to get back to the niche from which they had unwisely strayed. Some niche companies expanded into the general market and lost money because the differentiation that they enjoyed with the niche population was not attainable in the general market. They had to compete like everyone else, without the big edge from niche identity. Examples of niche companies that have headed back to their roots after getting badly burned in the general market include GEICO, Horace Mann, Colonial Penn and Foremost.

For the niche company, the benefits of loyalty have been a stable book of business and a consequent reduction of expenses. High renewal retention, or low churning of accounts, spares a company the higher cost of underwriting, pricing and opening records for new accounts. Renewal business is not only cheaper than new from an expense standpoint. It also produces lower losses. That is logical in auto, where the book is constantly being reunderwritten. The reasons are less apparent in homeowners, where companies do not reunderwrite often, but "seasoned" business has lower losses there too.

The niche company itself benefits from the stability and constancy which identification and loyalty bring. Over time, company staff will learn a lot about the needs of the target customers and about sometimes difficult techniques for meeting

those needs. A technical learning curve can be a formidable barrier to pursuit by competitors who envy the niche company's success.

Loyalty to the niche can be achieved by managing to a stated customer focus, but it is often reinforced by eligibility rules. Keeping identification with the niche and loyalty to and from it often call for sticking with niche people only. Many niche companies can afford to write liberally within the niche as long as they concentrate on it alone.

Access to the Niche

The three factors that recur at the beginning of niche insurance companies are closely related to each other and, to a degree, cause each other in a circular way. The efficient access to the target population which niche companies typically enjoy often follows from market neglect and from cohesiveness or identity within the niche. The founders were close to a group which they saw as not being served by established insurers. They figured out how to get the information about insurance to the people and how to set up the flows of money and information that in the insurance business are called "distribution" and "service".

The access which the niche company has to the niche population often looks, in retrospect, as though it was just there for the asking. In this respect, access has the quality of many a good invention that seems so obvious once somebody makes it happen, but it also underscores the importance of getting there first. Access often derives from a relationship that already exists. Examples are military officers selling to each other, and Japanese Americans doing the same, Foremost using mobile home lenders and dealers, teacher companies employing teachers to reach teachers, Chubb using commercial brokers to reach corporate executives, and, of course, formal sponsorship such as from the farm bureaus and auto clubs.

The main payoff is from being able to use lower cost distribution methods. Commissioned, independent agents, representing many companies, have been the norm in insurance for most of its history in this country. When personal lines niche companies first appeared, shortly after the turn of the century, independent agents were the only way to sell personal property-casualty coverage.

Then as now, the independent agents developed their clienteles and their own personal ties to customers. Under state law, the agents "owned the expirations" on the business placed by them, which meant they alone had the legal right to deal with the consumer on such subjects as what insurance to buy and from which company. Insurers were kept at one remove from their ultimate customers and essentially grew by appointing more agents. Under such an arrangement, regardless of how big an insurance company grew, its commission cost would keep pace and go up in direct proportion to volume. There were no economies of scale and, need it be added, commissions were high, often as high as 50% of the premium every year.

With pre-existing paths of access to the niche population, many niche companies bypassed agents altogether, using direct response. Auto club employees sold insurance from the home office by mail or phone. Armed Forces, USAA, GEICO, Agricultural Workers and Colonial Penn did the same. They did not need agents to get to their intended customers. Independent agents were not only unnecessary. They were regarded as part of the problem of market neglect, because they were mainly in the cities, not on the farms, and were too tied to localities to be able to serve customers constantly on the move, such as those in the military, civilian government or modern interstate corporations.

Other niche companies did employ agents, but they tended to be people in the niche, and they normally sold only the niche company's insurance. Often they were already serving the same people in some other way, as with farm bureau

representatives, Foremost's dealers, Western Pioneer's fellow ethnics and Preferred Risk's coreligionists in the abstaining niche market.

Access to the niche brings other efficiencies, harder to quantify but still valuable. Using independent agents and brokers imposes costs of coping with different systems, of duplicating some underwriting and recordkeeping functions and of filtering information, as it passes from customer to insurer, through an additional, fallible human being. Niche companies using exclusive agents or selling directly by phone or mail have simpler work flows.

Efficient access to the niche holds out the possibility of economies of scale, so elusive where independent commissioned sellers are employed. Niche distribution, predominantly by direct response and exclusive agency, means fixed investment before any business is written. Direct response calls for the most investment in advance, because all the work is done with company resources. But exclusive agency companies must also invest, by recruiting and training agents.

Economies of scale follow in any business where costs are fixed and a variable volume of business can be run through the same system. Unit costs then go down as volume goes up. That is surely another reason for niche companies' observable dedication to maintaining their volume of business, which comes through as stability and loyalty from the customer's standpoint, because the company's unit costs will go up if volume is allowed to go down.

EVALUATION OF INSURANCE NICHES

To evaluate niche insurance companies, it is necessary to adopt two different points of view, the public and the private. Niche companies affect how competition works, which is meaningful to consumers and to competing companies in the insurance business. We call that the private perspective. But niche companies also affect and are affected by one of the basic public policies toward insurance, the policy position regarding competition. We call that the public perspective for evaluating them.

The Private Perspective Niches, Competition and the Market

How Niche Insurance Companies Evolve

The niche companies profiled here had, at the beginning, the three common features of market neglect, common identity and efficient access. Thereafter they went different ways. Some became leading companies in the general market. Others grew large and became important while staying with the niche. Still others kept ties to the original niche while expanding selectively into the general market. A few just stayed small. Many, many niche companies failed or were merged away long ago.

In general, successful niche companies followed one of three paths.

First, some niches ceased being distinct because the companies serving them did well and then expanded out into the general market. In effect, the niche served as the original, secure base for a company that came to serve the entire market. When auto club insurers began, drivers were a small, elite band of enthusiasts. They became everyone. Farm bureau insurers began with a clientele distinct from the general

population in occupation, location and lifestyle. The companies followed the farmers into the suburbs where they mingled with people moving out from the cities. The government employee niche soon blended with managers and professionals in the private sector.

Second, sometimes the reverse happened, and the niche was absorbed by the general market. The established companies responded to the challenge and closed the market opening. They quit treating the niche as undesirable, or they devised ways to get at it efficiently or they created a separate rating class for it. Moving quickly, the establishment took back much of the business. The Japanese American niche is an example, as are the niches for old people and credit union members. From an institutional or historical perspective, when that happens the niche insurance company has accomplished its purpose. It provoked change, although the niche company itself may have been thwarted as a business venture and may, after only a brief life, have ceased to exist.

Third, some niches remained distinct but became large anyway. The military officer companies grew with the expansion of the services in two world wars and the cold war. The teacher companies grew with the school age population following the post-war baby boom.

Niches in Insurance and in Other Fields

This report concentrates on niche companies in personal property-casualty insurance. But they exist elsewhere. Appendix A describes niche companies in life insurance and commercial property-casualty. Nor are niche companies unique to insurance. They turn up all over the business landscape. Consumer goods retailing is full of them. Terms like "niche marketing" and "customer focus" appear throughout the management literature and in the daily business press.

The animating idea is similar to that behind niche companies in insurance. Someone sees a better way to meet the needs of a certain type of buyer. If the idea leads to lower costs, higher quality or a better fit with consumer needs, and if there are enough potential buyers, then the new idea stands a good chance of success.

When niche efforts succeed in any field, they are often catalysts for change. Even though a niche company may start as a specialized operation with a narrow customer base, it is often a pariah in the society of established providers. But much as the establishment may ignore or detest it, if the niche company attracts enough of their customers, it will eventually get their attention.

The impact of niche companies may be greatest in industries where competition is limited by agreement or regulation, where formal arrangements hold back change and adaptation to changing needs. For example, when commissions were fixed on securities exchanges, large blocks of listed stocks were traded off the floor. Before federal deregulation of airlines, overseas charter flights and intrastate carriers provided different classes of service and lower fares. The costs and rigidities of commercial banking, mainly inherited or regulatory, opened the way for the commercial paper market, savings banks, S&Ls, credit unions and the consumer and commercial finance industries.

Yet the record suggests that the niche phenomenon is unusually influential in insurance, even more so than in other businesses. The reasons why niche companies have even more impact in insurance than elsewhere have to do with the tradition of uniformity and resistance to change in insurance and with its unusual legal and regulatory history. The reasons for so much niche impact also trace to the way customer selection in insurance influences both distribution costs and loss costs.

The strength of a well conceived and well executed niche effort in insurance can be seen by analyzing it in terms of the textbook factors for competitive success in

any business. The factors are product differentiation and low costs. Almost by definition, the niche insurance company will be differentiated in the eyes of its customers, who usually were in on its creation. It will have low costs, thanks to efficient access and, usually, lower than average claims. Loss costs, the largest component of insurance prices, depend on selection of customers, and they appear quickly in financial results in the personal insurance lines. These are characteristics of insurance costs that have no counterpart in the cost structures of manufacturing and general merchandising.

Being the first to figure out how to price, underwrite and gain access to the niche population also leads the niche insurance company to what are called "first mover advantages" in the literature of general business. The first seller to move into an empty field can lock up a large share of the market while there are no competitors. When the second seller comes along, it finds the field already occupied.

Niche Insurance Companies as Agents of Change

The competitive advantages of a niche do not necessarily mean that nicheing is a ticket to success. Many niche companies have been beaten in competition. Many niches have been absorbed by the established market without a trace. Many have been nipped in the bud by regulators preventing them from passing savings on to members. Over the history of insurance in this country, far more niche insurance companies have failed than have succeeded.

But where the pre-conditions of neglect, identity and access are strongly present and the response is executed well, the emerging niche insurance company can be a strong competitor. Serving a segment better by serving it differently has enabled niche companies to influence the shape of the whole market. Their ability to attract customers away from established companies brings change to the market in one of two ways.

If established companies cannot or will not or for any other reason do not match to some degree the attractions of the successful niche company, then they are vulnerable to replacement. The niche becomes the vehicle for market evolution by replacement, the sort of creative destruction by which business competition operates. The best known farm bureau and auto club companies began with niches, succeeded there, applied their techniques to wider and wider segments and eventually grew to dominate the entire personal insurance market. Appendix C shows the process of replacement over the last 60 years in auto insurance. The early leaders either dropped down or left the ranks of the top twenty writers and were replaced largely by companies with niche origins.

Replacement is a model of competition more in tune with reality than the abstractions of some economists and regulators who postulate perfect competition and then deduce from it. Competition has brought large improvements in efficiency in personal insurance over the past three quarters of a century. But replacement rather than internal reform has been the story. Improvements have come from the change from independent agency distribution to exclusive agency and direct response. The change was largely brought about by niche companies.

But niche insurers that stay small and focused can also have great influence because of what they compel the others to do to defend themselves. They serve the industry as expensive demonstration projects. Consider how Colonial Penn changed the industry's ideas about older people as bad risks, and the parallel effect of Foremost for mobile homes, Chubb for the wealthy and Progressive for drivers with spotty records. Those were successes, but even failures are capable of provoking beneficial adjustments that the establishment would not have made if left alone.

We can sum up the evaluation of niche insurance companies from the private perspective by saying that they have been a form of protest against an unchanging

uniformity in the market. When they have proved their point that the uniform and rigid insurance establishment was wrong about the neglected group, they have been powerful instruments of change, particularly change in the direction of recognizing new and different needs and of passing back to consumers their own lower costs.

Whether by achieving replacement or by provoking imitation, niche insurance companies bring about change in an industry otherwise organized and regulated so as to be uniform and unchanging. They are the most effective single check on the formidable pressures for unchanging uniformity. For the public outside their immediate market focus, that is their greatest usefulness.

The Public Perspective Niches, Government and Public Policy

The Opposed Ideals of Uniformity and Competition

Throughout its history, the insurance business has been pulled between two ideals of public and business policy. One was to spread costs evenly over the largest possible population of premium payers, with community rating the ideal. The other was to price each policyholder in accordance with his or her own riskiness or likelihood to cause loss.

Both of those polar positions have merit, from both the business and the public point of view. Usually business and government occupy some middle or compromise position, but the principles themselves are absolute. A moderate result depends on keeping the opposing forces in some kind of balance.

Government can support either cost-based competition or community-rated uniformity. It can do so for perfectly sound public policy reasons. Over the years, government policy has swung like a pendulum between those opposed market ideals.

It is worth looking at how policy has shifted in order to understand the future implications for niche insurance companies.

The Original Government Policy Favoring Uniformity

Throughout the nineteenth century and well into the twentieth, business and government policy favored having companies agree on rates, policy forms and underwriting, with only the simplest rating and underwriting classifications. Some voices were raised in favor of competition. But even when the country adopted anti-trust rules for the rest of the economy, rules which would have prevented the sort of agreement necessary to rate all policyholders the same, the insurance business was kept apart and stayed with the ideal of controlled and uniform pricing. The reason was to make it easier for insurance companies to make money, both for their own benefit and for the public's benefit through reduced company insolvencies.

Niche insurance companies were the principal way the system of uniform rates was broken and price competition was brought to insurance. Niche companies emerged to bring better treatment, mainly lower prices, to certain kinds of buyers who had been identified by a prior relationship. Most important were the farm bureaus and the auto clubs. They were able to persist in the face of strong opposition – in numbers, money and political support – because the market advantages inherent in the niche effort were even stronger.

The Change to Government Policy Favoring Competition

As the successful auto insurance niche companies expanded deeper and deeper into the general market, it became harder for government to support a policy of not permitting low cost insurers to pass their savings back to buyers in the form of lower prices. Starting in the 1940s, the federal government tried to apply anti-trust principles and the states began to allow insurers to price according to their own costs.

The effect was that, after World War II, government changed sides in the debate over competition and, with it, over the issue of pricing the same or pricing against individual costs. Previously, the federal government had allowed insurance to have a pricing cartel, and the states had encouraged and enforced it. Now government at both levels wanted competition. It is hard to imagine a bigger shift in government regulation of business.

The high point of this swing of the public policy pendulum was in the late 1960s and early 1970s, when many states reject the old arrangement of requiring prior state approval of rates, which had exerted a strong pull toward uniformity. Instead they applied anti-trust principles, which pushed the other way.

With price competition proclaimed as both business and regulatory policy, low overhead costs and refined differentiation of risks became the best ways of competing. Classifications multiplied. It became harder to single out groups that were charged too much or otherwise neglected. Few niche companies were formed.

The Turn Away from Favoring Competition

Looking back, we can see the pendulum movement toward competition stopped and headed back the other way with two events of the mid 1970s.

The first event was the failure of the proposals for no-fault auto insurance to be adopted in anything like a pure form. Changing auto insurance from a liability to a first-party system was one way of resolving the internal instability of the line, at least in social and political terms. The instability came from its high overhead and its cost allocation. Auto insurance gave excellent benefits for middle and upper socio-economic groups, while sparing them the full impact of its high overhead costs through rating that fell regressively upon others. Pure no-fault was one way to attack

the overheads and the regressiveness. Several pure no-fault proposals were taken up at the state and federal levels in the early 1970s, but none was enacted.

The second event was inflation. The lurking problem with personal property-casualty insurance as a whole was that for a long time it had felt cheap to the consumer. That obscured any problems with comparative prices as among people and made highly credible the assertions of regulators and business that competition was the best way to a fair and efficient market.

Auto insurance prices had declined throughout the 1930s. The post-war price rises had been attenuated by the replacement of higher cost independent agency companies by lower cost exclusive agency and direct response companies during the same period. Homeowners insurance used dwelling fire insurance, whose premium rates far exceeded costs, as the core coverage. It then added ancillary coverages for no additional charge. Homeowners was such a success that it became fiercely price competitive during the 1950s and 1960s.

But homeowners insurance prices would go up if home prices went up, and auto insurance still had large overheads and regressive cost allocation. Judging regulation more by results than by theory, consumers could be expected to rethink their position on free competition if it allowed prices to go up as well as down. Less affluent consumers would have difficulty affording coverage, especially compulsory auto, in a general inflation. That is what happened in the 1970s. The date to mark would be the one when “affordability” was added to the list of proclaimed goals of regulation.

The stalling of no-fault and the oil shock inflation brought to a halt the pendulum movement toward price competition. Thereafter, government has swung public policy back toward controlling rates and flattening them as among people, especially so as to favor poorer people. The clearest confirmation was California’s

approval of Proposition 103 and the way it has been implemented so as to suppress rates overall and to suppress differences.

In all this, the position of government is crucial. As markets become more competitive and as information about the risk characteristics of policyholders becomes more accessible and inexpensive to obtain and analyze, the tendency of the insurance business will be to move toward pricing each risk on its own likelihood to cause loss. Where risk information is available to support differentials but community rating is nonetheless the public policy goal, there government or a private cartel will have to suppress competition and mandate the purchase of insurance at a prescribed price. That is the fact of market life underlying today's debates over government policy toward insurance underwriting and pricing.

Government policy toward niche insurance companies, whether it be for them or against them, is implicit in the policy choice between competition and uniformity. It brings us to the final topic of this report – the prospects for niche insurance companies.

PROSPECTS FOR INSURANCE NICHES

The Present and Immediate Future

In the early history of insurance in this country, the objective of efforts at uniformity in pricing and underwriting was to further the interests of insurance companies. That made sense in a developing country short of capital, with unsteady financial institutions and only rudimentary regulation to protect the public against insurer insolvency. In that setting, for government to encourage a pricing cartel, with high and uniform rates, was a sensible reconciliation of public and private interests.

Today, government's push for uniformity can be traced to a desire to accommodate entirely different interests. It is not to help companies or to protect the public against insolvency. Instead it seems to trace to the coming together of two objectives or influences. First is a familiar egalitarian political impulse. Reinforcing it is a relatively new one: satisfying the revenue needs of operators and clients of outside systems, such as law, lending and health care, that depend on insurance for funding. Since the failure to adopt pure no-fault auto insurance to replace liability, both those objectives are seen as having to be pursued while retaining the liability system.

Satisfying the revenue needs of other systems means making insurance compulsory. Keeping liability as the entitlement principle, together with normal techniques of liability rating and risk classification, would lead to high differentials in individual rates. Those differentials would be roughly opposite to ability to pay. So government sets out to suppress the differentials, that is, to go back to enforcing uniformity just as it did in the cartel days.

This need to suppress the price differentials, in turn, gives the egalitarian impulse great practical importance. Flattening out rates, when people know differentials are available that would benefit them, is politically tricky. If the total price is small or the differential is small, then people will go along with flattening, but that is no longer true of auto insurance anywhere and not of homeowners insurance in many places. The only evident way out is to stigmatize the differentiating characteristic as illegal, immoral or unfair, by arguing that it is wrong to treat people unequally because of the characteristic in question, perhaps because it is a proxy for another. That is one reason why current debates over territorial rating tend to be cast in terms of race, and why underwriting criteria such as age and gender are called unfair because they are beyond the individual's control.

Another way government suppresses differentials that are based on observed cost is to treat insurance rates as a form of taxation, invoking the fact that insurance is compulsory, so that the charges should be either the same or progressively rising with ability to pay. Another way is to regulate rates on the public utility model. Since that model presupposes the absence of competition, using it tends to destroy whatever competition does exist. The reasoning may be circular and even backward, but the demand for the result is insistent and effective.

However it is brought about, uniform treatment has never been a stable condition in insurance. Even in the heyday of the fire insurance cartel, the single-industry mutuals and reciprocals were rebels against a single set of terms. Health insurance began with community rating, but lower cost groups selected themselves out into other carriers and self-insurance. The whole risk management movement, now taking a third of commercial property-casualty premiums, began when corporate buyers of workers compensation could not get their workplace safety records reflected in their insurance rates.

Over and over again, the record is that uniformity will not last without enforcement. That is why uniformity is closely associated with coercion and with rigidity over time.

If measures to promote equal treatment bring uniformity to personal insurance, buyers are likely to try to find a way to break out. The analogy in commercial insurance to personal insurance niche companies is not the specialty commercial company. It is risk management. Commercial insurance buyers are opting out of the established casualty insurance system via self-insurance and captives, thereby keeping for themselves the savings from their own superior loss experience and easier accessibility.

Alternatives to the Niche Response

When the pricing cartels were in full force and had government support, the occasional company or agent that did not play ball, but did not have a niche as a base, was just driven out of the business. On the record, when the forces of unchanging uniformity are in the ascendant, the niche insurance company has been the only instrumentality of change and nonconformity strong enough to survive.

Today the pendulum swing toward uniformity has a long way to go and will surely get stronger before it turns again. At some point the movement toward uniformity will, and by its own logic will have to, try to brand niche insurance companies as unfair and try to stamp them out.

Were the niche response foreclosed in personal lines, there remains a response to too much uniformity that is analogous to the risk management response in commercial lines. It would be for people who believed themselves treated unfairly to buy all insurance above the compulsory amounts outside the reach of regulation, through some form of risk retention or in the surplus lines market.

Niche insurance companies should, in any case, be compared not with an idealized world of seamless equality, which somehow never happens, but instead compared with practical alternative ways people, if feeling sufficiently neglected and imposed upon, might come up with to temper the push for unchanging uniformity.

A more practical and less disruptive approach would be to pursue the objective of uniformity with some moderation, recognizing that it is not an eternal verity but rather one of two opposing principles between which public policy affecting insurance is always swinging back and forth. Niche insurance companies are one way those swings have been moderated in the past, and their record is instructive.

Conclusion and Outlook

Ultimately government will probably acknowledge that niche insurance companies are a useful counter-weight to enforced uniformity and safety valve for letting off resentment at neglect. Hobbling those that exist, or foreclosing the formation of new ones, would make as much practical sense as abolishing the insurance department in a burst of exuberance over free markets. The fact is that we are likely to need niche insurance companies to shake up the government-business establishment in the future, just as they have done in the past.

The overall conclusion to be drawn from all this history and analysis is that niche companies arise as a natural reaction of the insurance market to certain excesses that the market is naturally prone to. Those are excesses of sameness, inefficiency and inattention to customer needs. Those excesses are all too familiar in regulated industries. The excesses have great staying power, for they can be permanently congenial to industry and government. Unless something shakes them up. In insurance, niche companies are what shakes them up. Niche companies prompt the whole insurance market to change. Usually the change is toward greater

inclusiveness and greater efficiency. After the shakeup is over, the change usually turns out to be good for just about everybody.

APPENDIXES

APPENDIX A

Commercial Lines and Life Insurance Niches

Commercial Lines Niches

In the commercial property-casualty insurance market, that is, where the buyers are businesses and institutions as opposed to individuals, niche companies have had a long and extensive history. The commercial experience has many parallels with the personal market.

Niche companies emerged early in the fire insurance business. Still active today are the New England factory mutuals that were formed in the first half of the nineteenth century. The first was founded by cotton mill owners who built their factories with fire resistant materials and techniques and installed fire-fighting equipment, but could not get reduced insurance rates for these improvements. So the mill owners set up their own mutual. Others followed. A similar example was the department store reciprocal formed in New York City in the latter part of the century by merchants who had installed sprinklers but could not get a reduction in their fire insurance rates.

While these organizations expanded to become specialists in "highly protected risks" of many kinds, they began by insuring only firms in their own industry. They were successful because they understood the risks of their business and would not underwrite anyone that did not meet their construction and fire-prevention standards. They made thorough inspections, not only at inception but at renewal. The overriding idea was to prevent loss rather than to spread its cost.

Many of the mutuals and reciprocals listed in the early editions of *Best's Reports* most likely had similar self-help beginnings, although their individual origins are now obscure. The company names are suggestive. They include bakers, bankers, brewers, canners, cleaners, druggists, cotton ginner, grain dealers, hardware dealers, ice manufacturers, lumber companies, paint manufacturers, publishers and wholesale grocers.

These companies were the outlet for competition in a highly structured market. Commercial insurance companies, with the support of government, had formal agreements

that set uniform high rates, uniform underwriting criteria and fixed agent commissions. Even if an insured had good loss experience, rebating some of the premium was prohibited by law. Furthermore, breaking out classes of risks and charging them differently was considered unfair discrimination and hence was illegal under most state rating laws. The commercial fire insurance market in the U.S. in the late nineteenth and early twentieth centuries was in all respects a cartel in the technical economic sense.

Early commercial niche companies were in the mutual or reciprocal form because dividends and savings returned to policyholders were not controlled in the cartel world or regulated by the states. The mutual or reciprocal form was also convenient because states usually did not impose high minimum capital requirements on those corporate forms.

When workers compensation laws were passed by the states starting around 1910, casualty insurers sprang up around specific businesses for similar reasons. Bureau rates did not distinguish the better risks, so mutuals and reciprocals were formed by bakers, builders and contractors, coal merchants, fishermen, furniture makers, laundry owners, and printers and bookbinders. Again, in the early days of public liability insurance, there were niche companies for taxicab owners and New York City landlords. Many of these insurers were absorbed by others, some failed, and some moved into the general market. A few became major, national writers, such as Liberty Mutual and the Employers of Wausau.

In recent years when liability markets tightened, niche companies emerged again. In the mid-1970s, commercial insurers that had offered medical malpractice coverage left the market or would write it only at prices that appeared outrageous. Many state medical associations formed their own companies. The medical niche became even more finely divided as companies were set up for specific groups such as dentists, psychiatrists and nurses, because they had different loss profiles. During that period, other professionals, such as lawyers, accountants and architects also set up their own companies.

One could classify association captive insurers (those set up by firms in the same business) as niche companies. Risk retention groups might also be considered niche companies of a sort. In both instances, policyholders are in similar businesses or activities. More broadly, the entire risk management movement, which has transformed commercial

casualty insurance in the last thirty years, displays many of the distinctive origins and attitudes of a niche insurance company.

Life Insurance Niches

Although this study is about niches in property-casualty insurance, there are some useful examples of niches in the life insurance business, particularly the early ones of fraternal life, industrial life and the black life insurance companies that thrived for a time. Those niches were eventually absorbed into the general marketplace. But they shared two qualities with each other and with the property-casualty examples. Their opportunity lay in identifying a group of persons who were served indifferently at best and in reaching that group in novel ways.

The early niches of fraternal and industrial life were based on emerging financial needs of a working class. Rapid industrialization following the Civil War and waves of immigration transformed a largely agrarian, self-sufficient society to an urban one, dependent on jobs in factories and other mass employment. Working men needed a way to provide for their dependents, particularly in the event of death or disability. Insurance was one way, but the life insurance companies of the time were not interested in selling small amounts to the ordinary working man. His mortality was worse, and he had trouble keeping up premium payments.

Fraternal orders, many of which had antecedents in Europe, grew rapidly in the United States during the late 1880s and early 1900s. They were primarily social organizations formed by people of the same nationality or ethnic group, occupation or religion. Concern for protecting members' welfare naturally led to offering life insurance as a useful service. Some fraternal organizations, however, were formed specifically for the purpose of selling life insurance. The policies were cheap because many fraternal organizations operated on an assessment basis, collecting only when a death made it necessary to pay benefits. They did not pay commissions to agents and operated on a non-profit basis. For many years, fraternal benefit societies were not regulated because their life operations were viewed as a charitable service, and they were never taxed.

Industrial life was designed specifically to meet the needs of the factory worker earning a weekly wage. It used a different mortality table and contemplated frequent, small premium payments. It was an immediate success after its introduction in the U.S. in 1875. The early leaders were the Prudential Insurance Company of America and the Metropolitan Life Insurance Company. Selling costs were greater than for ordinary insurance, but the small amounts and weekly collection of premiums made the policies more affordable. By penalizing agents for accounts that lapsed, the "debit" system of computing commissions gave agents a powerful incentive not to make sales to prospects unlikely to keep up the payments.

Agents made weekly rounds of their territories, stopping by each policyholder's house or apartment to pick up the few pennies of premium. Shrewd agents timed their visits to follow close on the payment of weekly payrolls. By pausing to chat with family and neighbors, the agents turned up additional opportunities for sales.

Industrial life insurance held a fairly steady 18% share of all life insurance in force from 1900 through the late 1940s, but ever since has been in decline. Group insurance, usually an employer-paid benefit, and Social Security survivorship benefits have largely replaced it. The same sales technique still exists with monthly debit ordinary, whose premiums are paid to agents making monthly collections at the policyholder's home. Monthly debit ordinary and industrial life are commonly referred to as "home service" life insurance, and today the two account for only 1.2% of total life insurance in force.

An interesting chapter in the history of industrial life insurance concerns an apparent niche for African-American insureds. It also illustrates the importance to success of maintaining all three, not just one or two, of the qualities of successful niches.

Around 1900 the established life insurance companies, both those using the ordinary mortality tables for their rates and those using the higher mortality of the industrial life tables, concluded that African-Americans had mortality experience that was worse yet. As a result they refused to sell to that segment of the population or, if they did at all, it was at very high rates. Thus a significant part of the population was being neglected by the establishment, both the general agency life companies, which targeted middle and upper income people, and

the debit life companies, that targeted lower income people. So African-Americans formed their own insurance companies, many of which grew out of existing mutual aid societies.

By the middle of the twentieth century, there were over a dozen “black life insurance companies”. The largest of them, such as Atlanta Life, North Carolina Mutual in Durham, United Mutual in New York’s Harlem and Golden State Mutual in Los Angeles, were for a time very successful. They also provided valuable services to the minority community, such as office jobs and investment in home mortgages and local businesses.

But they were vulnerable for two reasons. They dealt with the problem of higher mortality cost by building their rates upon a mortality component even higher than the industrial mortality tables. And their expenses were high, because, given the technology of the time, they were unable to capitalize on their access to the target clientele to build a low cost method of distribution. So their pricing combined the higher mortality of a substandard industrial life table with the higher expense of small-unit, debit life agency.

Eventually the established life insurance industry decided that, for business and community relations reasons, it could no longer afford to neglect the African-American market the way it had in the past. Starting not long after the Second World War, the big “white life insurance companies” came after the special market of the black companies and especially the higher income portion of it. Their competitive advantages were lower prices and better reputation for financial strength.

The niche companies in the African-American community could not compete. They went into a decline that continues today. Yet, even if none were to survive, the African-American niche life insurance companies succeeded in the other way niche companies can, by pushing the establishment to stop neglecting their segment of the market.

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APPENDIX B

Past and Present Insurance Niches

with Company Examples, Date Niche Company or Niche Effort Started, and Current Status

NICHE	COMPANY EXAMPLES	NICHE START	STATUS TODAY
Automobile Club Members	Automobile Club of Southern California Automobile Club of Michigan Automobile Club of Missouri California State Automobile Association Chicago Motor Club Keystone Auto Club	1912 1922 1927 1914 1917 1928	General General General General General General
Farm Bureau Members	State Farm Nationwide Alfa Mutual Southern Farm Bureau American Agricultural	1922 1925 1945 1947 1948	General General Niche Niche Niche
Military Officers	Armed Forces Insurance Exchange United Services Automobile Association	1887 1922	Niche Niche
Government Employees	Civil Service Employees GEICO	1949 1936	General General
Teachers	Agricultural Workers Mutual Horace Mann Michigan Educational Employees PEMCO	1948 1945 1950 1949	Niche Niche Niche General
Old People	Colonial Penn	1967	General
Other Personal			
Non-Standard Auto Risks	Progressive	1956	General
Wealthy People	Chubb	1976	Niche
Mobile Homes	Foremost	1952	General
Japanese Americans	Western Pioneer	1949	General
Non-Drinkers	Preferred Risk Mutual	1947	Niche
Credit Union Members	League General	1968	Niche
Commercial			
Businesses in the Same Industry	Early factory mutuals	1835	General
Similar Institutions	Association captives	1970s	Niche
Like Professionals	Medical malpractice companies	1970s	Niche
Life Insurance			
Fraternal Benefit Society Members	Fraternal life companies	1850s	General
Workingmen	Industrial life companies (e.g. Prudential)	1870s	General
African-Americans	Atlanta Life	1916	Niche

APPENDIX C

Leading Private Passenger Automobile Insurers

Ranked by Net Written Automobile Premiums

	1930	1940	1950	1960	1970	1980	1990
Aetna	8 *	7	9	6	4	5	6
Allstate	–	–	5	1	2	2	2
American Family	–	–	–	–	–	15	11
American Auto (pre Fireman's Fund)	12	2	12	13	–	–	–
Auto Club of Michigan	–	19	–	–	–	16	15
California State Auto Association	–	–	–	–	–	20	9
Cigna	15	20	–	18	–	13	–
CNA	17 *	15	20	19	–	–	–
Commercial Union	2 *	8	16	17	18	–	–
Continental	4 *	16	10	5	9	11	–
Erie	–	–	–	–	–	–	18
Farmers	–	12	3	9	8	3	3
Fireman's Fund	–	–	–	14	13	17	–
Firemen's of Newark (pre Continental)	13	–	–	–	–	–	–
GEICO	–	–	–	–	–	9	7
General Accident	7	10	18	16	–	–	20
Hanover	20 *	–	–	–	–	–	–
Hartford	5	5	4	4	5	18	12
Home	–	–	–	20	14	–	–
Interins Exch Auto Club S CA	–	–	–	–	19	12	16
Kemper	9	3	6	15	12	8	–
Liberty Mutual	–	6	8	10	7	7	8
Maryland Casualty (pre Zurich)	10	17	14	–	–	–	–
Motors	–	–	–	7	16	–	–
Nationwide	–	18	7	8	6	4	4
Orion Capital	18	–	–	–	–	–	–
Progressive	–	–	–	–	–	–	17
Prudential	–	–	–	–	–	14	13
Reliance	11	–	19	–	20	–	–
Royal	3	9	11	–	17	–	–
Safeco	–	–	–	–	–	–	14
Sentry	–	13	17	–	–	19	–
State Farm	14	4	1	2	1	1	1
Travelers	1 *	1	2	3	3	6	10
Twentieth Century	–	–	–	–	–	–	19
Union Indemnity (failed 1933)	19	–	–	–	–	–	–
USAA	–	–	–	–	15	10	5
USF&G	6	11	13	11	11	–	–
Zurich	16	–	–	–	–	–	–

Notes: Insurers with identifiable niche beginnings are printed in bold type.
 Insurers that included other liability with auto liability in 1930 are noted with an asterisk.
 Rankings are based on groups and how they were configured at the time.
 1930 - 1970 rankings are based on private passenger and commercial automobile premiums.

APPENDIX D**Personal Property-Casualty Niche Companies Cited in this Report**

Agricultural Workers Mutual	Agricultural Workers Mutual Auto Insurance Company 5500 Lower Birdville Road Fort Worth, Texas 76117 817-831-9900
Alfa Mutual	Alfa Insurance Group 2108 East South Boulevard Montgomery, Alabama 36116-2015 205-288-3900
American Agricultural	American Agricultural Insurance Company 225 Touhy Avenue Park Ridge, Illinois 60068 312-399-5700
Armed Forces Insurance Exchange	Armed Forces Insurance Exchange 550 Eisenhower Road Leavenworth, Kansas 66048 913-651-5000
Automobile Club of Michigan	Automobile Club of Michigan Group 1 Auto Club Drive Dearborn, Michigan 48126 313-336-1234
Automobile Club of Missouri	Automobile Club of Missouri Group 12901 North Forty Drive St. Louis, Missouri 63141 314-523-7350
Automobile Club of Southern California	Interinsurance Exchange of the Automobile Club of Southern California 2601 South Figueroa Street Los Angeles, California 90007 213-741-3111
California State Auto Association	California State Automobile Association Inter-Insurance Bureau 100 Van Ness Avenue San Francisco, California 94102 415-565-2012

Chicago Motor Club	Chicago Motor Club Insurance Company 999 East Touhy Avenue Des Plaines, Illinois 60018 847-390-9000
Chubb	The Chubb Group of Insurance Companies 15 Mountain View Road Warren, New Jersey 07059 908-903-2000
Civil Service Employees	Civil Service Employees Insurance Company 989 Market Street San Francisco, California 94103 415-495-6800
Colonial Penn	Colonial Penn Group 2650 Audubon Road Norristown, Pennsylvania 19403 610-650-2000
CUMIS Insurance Society	CUNA Mutual Insurance Group 5910 Mineral Point Road Madison, Wisconsin 53701-0391 608-238-5851
Foremost	Foremost Corporation Group 5600 Beech Tree Lane Caledonia, Michigan 49506-0050 616-942-3000
Government Employees	GEICO Corporation One Geico Plaza Washington, D.C. 20076-0001 301-986-3000
Horace Mann	Horace Mann Insurance Group 1 Horace Mann Plaza Springfield, Illinois 62715-0001 217-789-2500
Keystone Auto Club	Keystone Insurance Companies 2040 Market Street Philadelphia, Pennsylvania 19103 215-864-5000

League General	League General Insurance Company (member of CUNA Mutual Group) 30200 Telegraph Road Bingham Farms, Michigan 48025-5402 810-901-1600
Michigan Educational Employees	Michigan Educational Employees Mutual Insurance Company 691 N. Squirrel Road, Suite 200 Auburn Hills, Michigan 48326-2849 810-373-5700
Midwest Mutual	Midwest Mutual Group 1111 Ashworth Road West Des Moines, Iowa 50265-0600 515-223-5000
Nationwide	Nationwide Group One Nationwide Plaza Columbus, Ohio 43216 614-249-7111
PEMCO	PEMCO Insurance Companies 325 Eastlake Avenue East Seattle, Washington 98109 206-628-4000
Preferred Risk	Preferred Risk Group 1111 Ashworth Road West Des Moines, Iowa 50265-3538 515-267-5000
Progressive	Progressive Insurance Group 6300 Wilson Mills Road Mayfield Village, Ohio 44143-2182 216-461-5000
Southern Farm Bureau	Southern Farm Bureau Insurance Group P.O. Box 1800 Ridgeland, Mississippi 39158-1800 601-957-7777
State Farm	State Farm Group One State Farm Plaza Bloomington, Illinois 61710 309-766-2311

United Services Automobile Association

USAA Group
9800 Fredericksburg Road
San Antonio, Texas 78288
210-498-2211

Western Pioneer

Western Pioneer Insurance Company
5000 Hopyard Road
Pleasanton, California 94588-3350
510-847-9742

Authorship of the Report

Stewart Economics, Inc. is a consulting firm specializing in insurance and insurance regulation.

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The report was prepared at the request of United Services Automobile Association, which has paid for its preparation, but the views expressed are those of Stewart Economics.