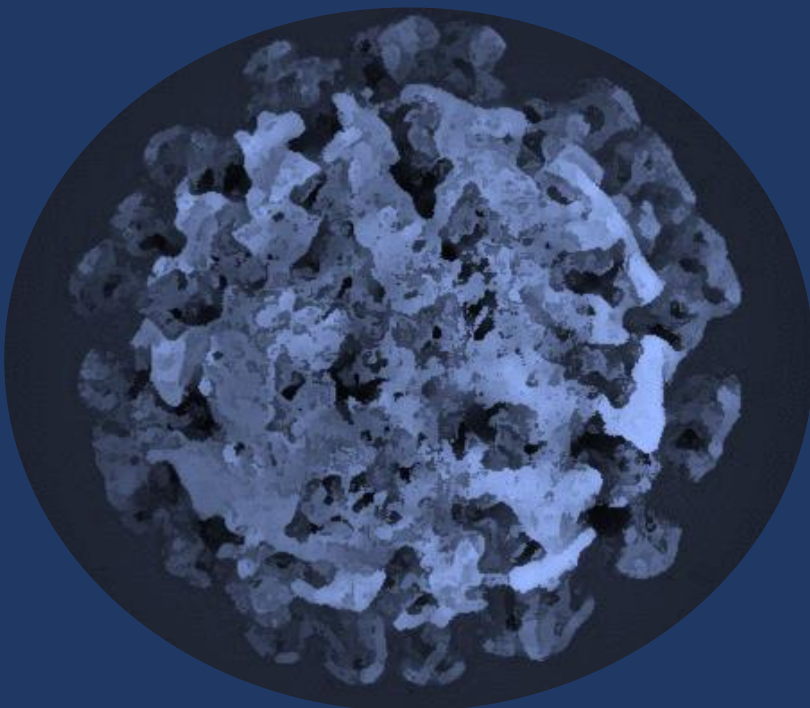

COVID-19 and Auto Insurance:

Evaluating the impact of COVID-19 on the Auto Insurance industry and embracing potential opportunities

Part 3: Distribution – Impact by Primary Channel

OUTPERFORM ASSOCIATES

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Abstract

In Part 1, we showed how revenue pressure on the insurance space mandates quick, decisive, and, most importantly, tailored approaches to be taken by every company; the winners in this crisis will be those that identify the unique threats to their business and the unseen opportunities from the crisis, and develop strategies and executable plans to address these challenges and opportunities. This document continues to outline the key, foundational considerations building that strategy and operational plan.

In Parts 2 and 3, we will explore the impacts of COVID on distribution; Part 2 will explore the impact on distribution within each market segment while, in Part 3, we will focus on the impact by primary distribution channel as insurance companies begin to plan the path forward for their unique situation.

In this 6-article series we will:
- Explore the critical ways in which the auto insurance industry has been impacted by the COVID-19 crisis
- Share the thoughts and reactions of 14 auto insurance CEOs, Presidents, and EVPs
- Define many of the significant challenges ahead, and begin to look at the opportunities this situation may offer across interrelated and interdependent topics, including:
    1. Revenue Pressure and Preservation
    2. Distribution (COVID Impact by Market Segment)
    3. **Distribution (COVID Impact by Primary Distribution Channel)**
    4. Pricing and Underwriting
    5. Profitability
    6. Innovation

Methodology

This series is predicated on OutPerform's experience in the auto insurance space and extensive research into the present environment due to the COVID-19 pandemic. The challenges and hypotheses discussed in these articles were created in conjunction with CEOs, Presidents, and EVPs of more than a dozen companies in the auto insurance space, including executives from a Top 5 auto insurer, Mid-Sized Standard auto carriers, Non-Standard auto carriers, MGA's, and Insurtechs.

In our interviews with these executives, we found general agreement on some topics, and stark differences on others. Most of these differences correlate to the respondent's position in the marketplace (e.g. capitalization, rate adequacy, customer profile, state footprint, etc.). Based on all of these inputs, we have developed the most probable outcome(s). As a final note, due to the novel nature of our current environment, it's worth noting that the challenges we address here, and our recommended solutions, may change over the coming months.

Given the sensitive nature of some responses, our contacts asked that their comments be anonymized. We appreciate the input of all of the executives that shared their thoughts and time.

Executive Summary

In Part 2 of this series we discussed the impacts, challenges, and opportunities created across each market segment as a result of COVID-19; in Part 3, we apply the lens of distribution channel to these segment-specific insights.

Independent Agency (IA) based companies face the greatest threats and challenges from the changes to consumer purchasing behaviors, but COVID will create unique challenges for companies in every distribution channel. Some of these challenges will constitute existential threats, while others will require updates to processes, data collection and reporting, or technology, and still others will create additional cash flow pressures, expense ratio issues, staffing challenges, or the need for greater expertise. As we examine this further, it's clear that some distribution channels and companies are inherently in a better position to address this crisis and capitalize on opportunities, while other companies must move quickly to avoid significant damage to the business going forward. Every company will be forced to reevaluate their approach to the market.

The need for each company to have a holistic strategy will become more apparent as we discuss the relationships between channels and segments in this document, and pricing and underwriting in Part 4.

Depending upon each company's, or reader's, position in the market place, the various concepts in this document may range from being informative, to seeming more rudimentary. However, we believe every reader will benefit from the insights provided.

Distribution: COVID Impact by Primary Channel

As discussed, the economic impact of COVID will affect all distribution channels. We'll examine this impact across the various forms of traditional carriers, MGAs and Insurtechs.

Traditional Insurance Carriers: From Captive and Independent Agent-based carriers, to Direct and Multi-Channel carriers, Traditional carriers face substantial, but differing distribution challenges correlated to the channel(s) they use.

Independent Agent (IAs) Channel:
Executives from IA-based carriers noted COVID's potential to permanently reduce personal lines volume in the IA channel and described the pandemic as an existential threat to many, weaker carriers.

Executive Comments on IA Channel after COVID

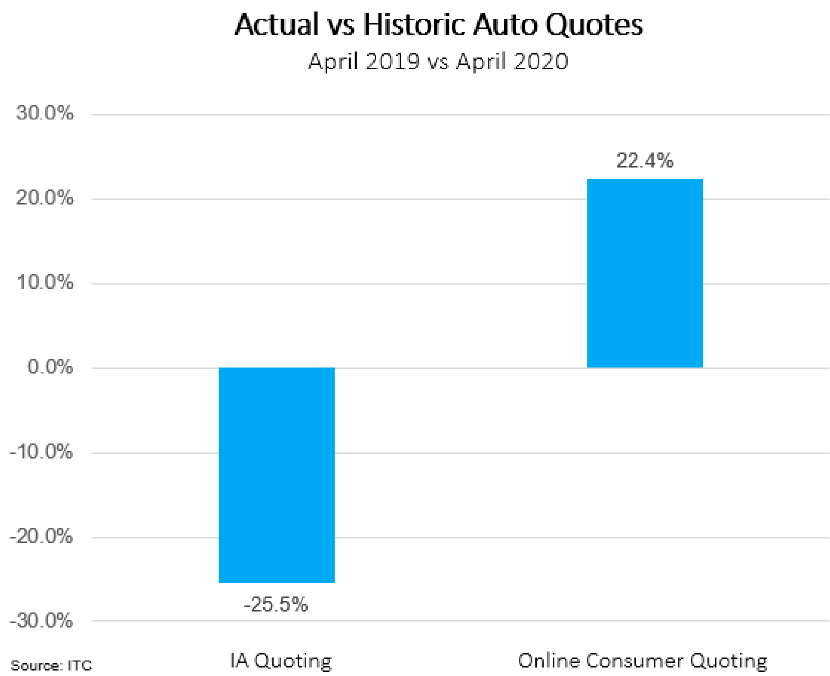
"We will have less written premium in two years and I don't know if we will be able to get that back from the existing IA base."

"We are well capitalized, so we will ultimately be OK, smaller, but OK."

"More consolidation is going to come out of this, and the walking dead are going to die faster."

CEO interviews, May 2020

In the IA- channel, carriers and their agents have the greatest amount of risk due to COVID; while we anticipate heightened shopping in the coming months, social distancing is substantially reducing, or even eliminating, traffic to brick and mortar offices. As a result, ITC has seen IA-based comparative quotes fall 25% below the company's seasonal projections[1]. Continued social distancing and a reluctance for many to leave quarantine for non-essential purposes will cause further shifts to online and phone quoting in the coming months. This could be devastating to a channel that currently only captures 29% of the auto insurance market.



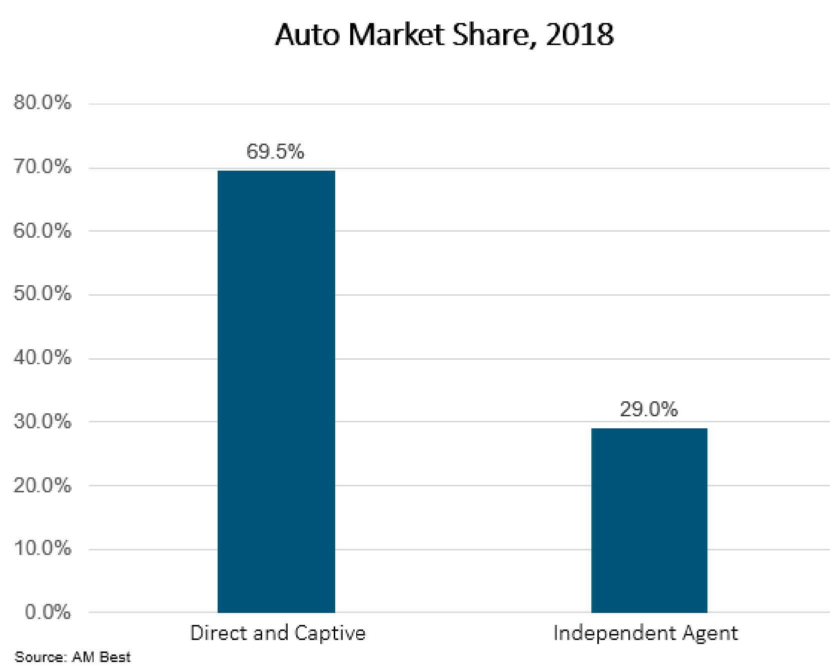
This begs five questions:

1. Over the next 24 months, how much of the new phone and online quoting traffic can local agents capture?
2. While the pandemic impacts consumer behavior, how much of the IA's personal lines customer base will erode, or can this be avoided?
3. Once COVID is gone, will changes in consumer behaviors prove to be permanent?
4. How/will IAs adapt, or will there be a long-term erosion in market share?
5. How/will IA-based carriers adapt?

As we've discussed, all auto insurance carriers face significant revenue, pricing, and profitability challenges (pricing and profitability addressed in Parts 4 & 5), and the potential of a soft market. The IA operational model has the benefit of offering multiple rates to consumers but has structural challenges, compounded by the COVID shutdowns, including:

- The inability to effectively deploy best practices across the agency force
- The lack of aligned interests between agents and individual carriers especially in a soft market (i.e. IA's will focus on agency retention, not carrier retention in a soft market)
- Reliance on offline marketing and in-person visits for a large number of agencies
- The massive marketing budgets and brand credibility of DWs and Captives

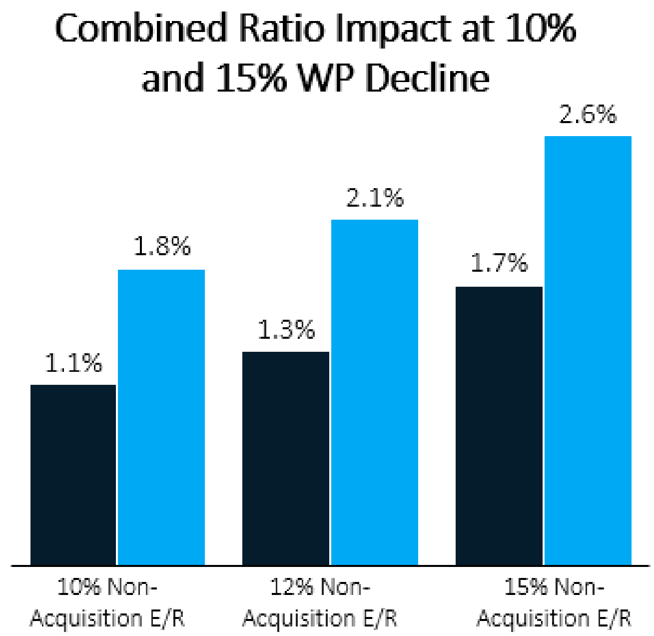
IA-based carriers therefore face difficult decisions around distribution, as they attempt to retain market share. This is true for all IA carriers, but will be more critical for monoline auto carriers where consumer switching costs are lowest.



To overcome these obstacles, all IA-based carriers will need a strategy to get traffic from the Direct channel. Those with existing distribution strategies focused on larger platform agencies, tech savvy agencies drawing web-based traffic, and companies utilizing personal lines as an accommodation for their commercial book are best positioned to minimize the impact to PIF counts. Conversely, IA-based carriers with high expense ratios, high writing to surplus ratios, limited technical and reporting capabilities, and significant dependence on

IAs with limited access to consumers online or over the phone will need more robust strategies.

Carriers unable to overcome a declining auto market share in the IA channel will face higher expense ratios; for example, a 10%-15% decline in IA channel volume could result in as much as a 2.6-point increase in expense and combined ratios which would be devastating for companies with already slim margins, particularly at a time of very low investment returns. Raising rates (rendering them even less competitive), cutting costs, identifying other sources of business, or deploying a strategy of getting a greater share of a shrinking market are the only solutions for carriers in this situation.



To avoid potentially permanent damage to a company's market position, IA-based carriers must be capable of forming a strategy and action plan responding to these key questions[a]

- Where does auto insurance fit in the carrier's overall strategy?
- What are the technical and operational capacities of the carrier and its agency force?
- How does the carrier optimize operations? Is there an existing optimization process?
- Is the carrier strong enough to grow by dominating a shrinking segment?
- Is there a better way to collaborate with (at least some) agents in a path forward?
- Will the carrier's new strategy require a new agency alignment?
- Are there technological or Insurtech solutions that can help standardize processes with agents, and facilitate improved implementation of best practices?
- How do IA carriers attract traffic back from the Direct channel? Should the carrier take a multi-channel or modified multi-channel approach? What would that look like?
- What are the short-term cash flow and expense ratio implications of frontloading acquisition costs in any effort to draw business back from the Direct channel? Does the carrier need to place greater emphasis on lifetime value (LTV) as a result of this process?
- Does the carrier have the culture, internal resources, and skill sets to build and execute a strategy to address the effects of COVID, or are outside resources required?
- Does the carrier need to collect new and different data or change their reporting systems? Are the carrier's culture, processes, and systems easily adaptable and nimble?
- How financially sound is the carrier?
- Does the carrier need structural program changes to improve retention prospects?

The path forward for IA carriers is not yet clear, but formulating a solid strategy with the requisite plan, milestones, reporting, skills, and resources in place quickly is essential.

Captive Agent Carriers (Captives): While Captive carriers face the same COVID-related operational and distribution challenges as IA-based carriers, their contractual control over all products, systems (rating,

[a] Non-Exhaustive

underwriting, CRM, reporting, etc.), and the rules of engagement associated with their distribution channel enable them to better manage their COVID response. The Captive carrier structure, unlike IA-based carriers, creates the ability to:

- Institute a cohesive strategy across the company and distribution channel
- Identify and deploy best practices across the agency force
- Develop multi-channel activity in coordination, rather than competition, with the existing distribution channel
- Initiate actions in response to the effects of COVID designed exclusively to address the company's objectives through their distribution channel
- Possess better end-to-end data on consumer behavior from quoting through retention
- Institute, modify, and train staff on new processes more effectively
- Effectively push technology, software, and telephony solutions to all of their agents
- Have a known brand to consistently message the company's actions through marketing or media and the distribution channel
- Adapt and retarget agents marketing and distribution efforts to traffic with higher rates of conversion and retention, assuming the right data and reporting is available

All of this is to say, Captives are better positioned to identify and execute on opportunities to come out of COVID stronger. Whether these carriers can leverage the model's benefits depends on their level of execution prior to the start of the pandemic. In addition to the questions outlined for IA-based carriers, Captives must add more channel-specific questions when developing a COVID response strategy[b]:

- How well has the company executed and leveraged the benefits outlined above to this point?
- Are the carrier's culture, processes, and systems adaptable and nimble?
- Have existing processes and systems enabled the company to:
  - Collect and report on meaningful distribution data (quoting, conversion, servicing, telephony, etc.)?
  - Integrate distribution data with policy and retention data?
- Can the company adapt data collection and reporting to develop:
  - Newly relevant views of consumers characteristics and behaviors?
  - Establish new processes and data flows?
- Does the company fully understand and track work flows and behaviors within the local agencies? Is there an existing optimization regimen in the distribution processes?
- How well capitalized is the company?

Direct Writers (DWs): As consumers become increasingly price sensitive due to massive layoffs, auto insurance shopping increases, and consumers gravitate to online and phone interactions, DWs will be best positioned among traditional carriers to attract insurance shoppers, thus increasing market share.

Of course, DW's opportunity to expand market share comes with its own set of challenges. Even the biggest and best-positioned players in the Direct space (GEICO, Progressive, Liberty Mutual, Permanent General, and others) are not immune to these challenges. While a number of these issues are "good problems to have," some are just "problems," including:

- Increased shopping will result in more direct policies; however, we expect this will also reduce buyers on a percentage basis. Lower conversion rates will result in higher acquisition costs-per-policy through:
  - Higher third-party data costs-per-policy

[b] Non-Exhaustive

    - Higher average talk time-per-policy sold
- An influx of consumers unfamiliar with online purchasing will increase average talk time
- Uncertainty over COVID-related changes to call volume, workforce attrition, staffing needs, absences or shrinkage, or changes to efficiency will drive sales center staffing, cost and quality issues
- Increased marketing expenses, overall and per policy
    - It's possible there may be downward pressure on the cost-per-lead/click due to a significant increase in traffic but we also expect the quality (measured by policy conversion) to decrease, and consequently the marketing cost-per-sale to increase
    - Substantial increases to lead volume and decreases to conversion will increase the average marketing cost-per-policy
- Additional pressure on profits (see Part 5) lower retention rates and a lower allowable acquisition cost-per-policy

For DWs to take full advantage of this shift in consumer purchase behaviors it will be essential to have a highly adaptable plan in place, as consumer buying behaviors and retention rates shift across all segments, marketing spending yields change, and sales center staffing and scheduling needs may show considerable volatility as events unfold.

Executive Comments on Distribution after COVID

"This isn't going anywhere it wasn't already going. We are just going to see a material acceleration in changes to distribution…The way they (consumers) are having to buy policies is changing. They are being forced to do things differently and will develop a comfort level."

"We are accelerating our movement into new channels…we have been looking at this and talking about it forever…stuff like this forces us to move forward."

CEO interviews, May 2020

Multi-channel – Agent and Direct: Aside from a couple of notable pure DWs, most Direct channel carriers operate in other channels concurrently. In fact, the Captive or IA channel is the primary auto insurance distribution channel (50%+ of new business) for most of these carriers. Even Progressive did not reach 50%+ direct distribution until 2018[2]. As a consequence, the direct capabilities of Multi-Channel carriers vary dramatically.

This crisis represents a critical juncture for most Multi-Channel carriers, and for carriers who have only contemplated how to get business back from the Direct channel.

As consumer shopping increases and migrates toward online and phone transactions, the impact to carriers, like so many other issues with this pandemic, will be uneven; each carrier's state footprint, shutdown durations, the degree of unemployment by territory, market segment(s) served and the carrier's position prior to COVID will determine the scope of challenges and the degree of urgency they face in defining plans and strategies.

Developing a strategy starts with each carrier's current situation.

As we outlined above, carriers with effective direct operations will face a number of distribution challenges centered on predicting and meeting near term demand requirements, while addressing near-term decreases in retention and the resulting decrease in acquisition allowable.

Carriers with a direct operation that is not yet fully effective in attracting profitable business in a cost-effective manner will feel the same short-term Direct challenges more acutely. These carriers will need to act with a greater sense of urgency in reaching their target acquisition allowable if they are to capitalize on market conditions associated with possibly permanent shifting consumer behaviors and market share shifts. Each carrier will need to initiate or accelerate optimization processes, develop a better understanding of the questions that must be considered, expand data gathering and reporting capability, and add the expertise necessary to improve the conversion and retention dynamics and reach the target acquisition allowable.

In many cases, carriers with no existing efforts to access Direct channel traffic or actual direct efforts will need to develop short and long-term strategies to address the shift in consumer buying behaviors. For some, this will involve accelerating long-considered Direct initiatives, while others will scramble for alternative solutions. Having a direct strategy can take many forms, and the right strategy needs to fit the individual carrier's circumstances. In developing a strategy, there are many things to consider, including:

- What consumers in the carrier's target segment(s) are demanding, and how their shopping behaviors are changing
- The company's current position in the marketplace, financial condition, and other internal priorities and challenges
- The carrier's primary distribution channel and how to leverage, complement, or co-exist with that channel in obtaining business from consumers shifting to shopping and purchasing online or over the phone
- The company's existing capabilities and any external expertise or resources that may be necessary in the near term
- The carrier's overall short and long-term strategy and goals
- The available timeframe to have a viable solution
- The unique process and financial dynamics of accessing Direct channel consumers (e.g. in many instances either the company, or if an agent remains involved, the agent will need to front load acquisition costs, creating potential cash flow concerns)

It is important for all carriers to develop and begin implementation of a strategy for the effects of COVID. Each carrier's individual situation, vulnerabilities, strengths, and long-term corporate goals should dictate the carrier's level of urgency in creating their strategy.

MGAs: Most MGAs operate in the NSA market segment and operate through independent agents. In addition to the challenges noted across segments and channels, MGAs face significant additional threats, including:

- Premium returns and non-pay cancel moratoriums, where mandated, will strain margins and, in extreme cases, could result in insolvency for MGAs that are thinly capitalized
- Fronting companies, assuming some degree of indemnity risk, may choose to terminate MGA agreements as soon as contractually possible to mitigate losses and then return when the market is more stable
- The impact of COVID on reinsurers across lines of business, claims payments on unfunded cancellations, and a reduction in ceded premium (through reduced retention and a reduced share of new business traffic through IAs) could result in much less favorable reinsurance pricing for MGAs going forward

The potential of higher costs, lower premium, and reduced volume could result in a significant financial squeeze for many MGAs. The challenges from COVID to the NSA segment and the IA channel, combined with MGA-specific challenges will result in the demise of some MGAs within the next twenty-four months.

Insurtechs: In this document we address the impact of COVID on Insurtechs that have entered the auto insurance market as a "full stack" carrier or an MGA. Insurtechs face the same challenges as traditional carriers, as well as some additional problems, but also have unique advantages. As an example, Insurtechs' technologically-driven models (e.g. telematics and tracking driving behaviors, marketing to consumers at key inflection points with a higher probability of conversion, etc.) should provide these companies with pricing and marketing advantages, while more agnostic approaches to distribution channels free them from channel conflict concerns and any overreliance on local agents during the current pandemic.

Additionally, Insurtech carriers tend to possess nimbler systems and data architecture enabling a quicker pivot than traditional carriers, but may need to augment their operational expertise in response to consumer's shift toward online and phone-based transactions.

Finally, some insurtechs utilize targeting algorithms to significantly decrease online acquisition costs per sale; if these algorithms can adapt to population mix changes driven by COVID, and lead generation tactics can adapt to reach the new mix of shoppers, these Insurtechs will be well-positioned to obtain a disproportionate share of new business.

As for additional challenges, insuretechs' lack substantial renewal books to offset much higher loss ratios on new business gained due to the pandemic. This will put pressure on short term profitability and surplus, and while these companies are typically heavily reinsured, could result in additional pricing pressures in future reinsurance contracting Additionally, while we anticipate a coming soft market in auto insurance, we believe there is the possibility of a coming hard market in reinsurance, as reinsurers face tremendous exposure from COVID in many lines of business. Since Insurtechs tend to be heavily reinsured, they may face additional cost pressures in 2021.

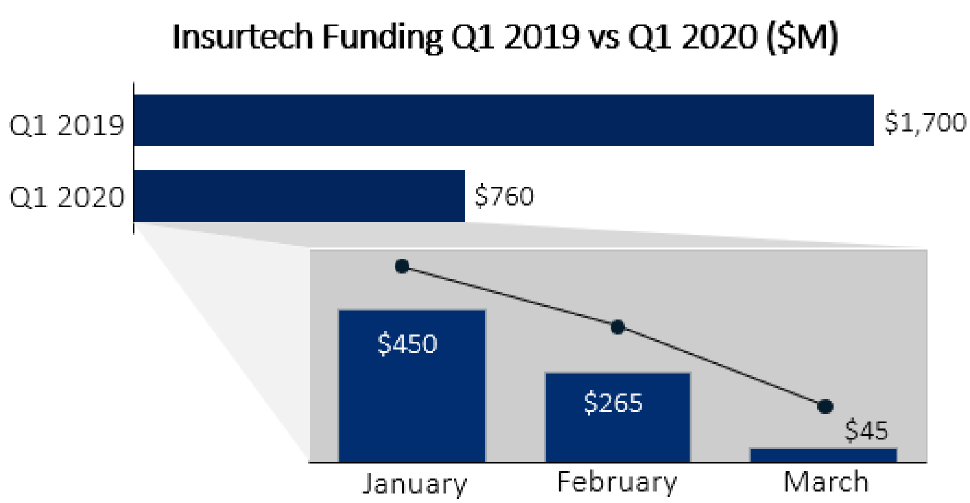
Thoughts on Reinsurance

"The Pandemic is resulting in increased losses across a variety of lines that are not priced into reinsurance agreements. Its early, but I don't see how this doesn't turn bad the rest of this year. I am not looking forward to renegotiating (reinsurance) later this year."

"Regarding rate hardening in reinsurance, I would say the early indicators are that is happening somewhat but it is too early to tell..."

CEO and EVP interviews, May 2020

Under normal circumstances, the average traditional carrier has reached the point of being financially self-sustaining. Insurtechs are typically not yet profitable and consume significant amounts of invested capital in pursuit of scale and profitability. COVID has caused Insurtech funding to plummet 90% from January to March and is not expected to increase in the next two quarters. Insurtechs with sufficient funding to sustain them through Q2 2021 may be in the perfect position to take advantage of the current crisis to increase their market share. Unfortunately, some Insurtechs may run short of funding just as their opportunities are increasing.



Source: Insurtech Funding Roundup, Q1 2020: Investors Reduce Risk as the COVID-19 Induced Downturn Settles In Forbes, May 1, 2020

Conclusion:

The COVID crisis has many challenges and complexities, but the ultimate impact will be to accelerate existing trends. Weak companies from a capitalization, financial, operational, pricing, and technical perspective will get weaker faster unless they adapt quickly. On the other hand, stronger companies have the opportunity come out of the COVID in a better position; how these companies react will determine whether they take advantage of this situation. There is no predetermined outcome to all of this, but, again, each company's starting position should dictate the urgency of the situation.

IA-based carriers and MGAs face the greatest challenges over the next twenty-four months. Some of these companies will collapse, having been unable to withstand the market and financial damage. The death of "the weak sisters," as one CEO commented will be accelerated by the COVID crisis. Some of the stronger IA-based companies will capitalize on weaknesses from other IA-based carriers, seizing a greater share of a fast-shrinking market segment, while others will look to move to more of a multi-channel approach.

Almost all companies will need to develop a strategy and an executable plan to address the changes in consumer purchasing practices. Again, we believe it is essential that every carrier and MGA in the insurance space step back at this critical moment to assess their unique situation, and how this crisis will affect the company and their customers.

"The adverse effects of COVID-19 were immediately felt in the insurtech marketplace as investors and insurers curtailed investments amid economic uncertainty and market volatility."

"Looking ahead to the next two quarters, I expect that insurtech funding will continue to wane as the near-term economic picture remains uncertain, which will drive investors and insurers alike to deploy capital preservation strategies."

Insurtech Funding Roundup, Q1 2020, May 1, 2020

Across all distribution models and market segments companies face the potential of declining retention levels due to the financial impact of COVID. Those who have had limited (or no) efforts to attract direct traffic to this point independently or with assistance from more sophisticated agencies will be at a significant disadvantage in attempting to address the consumers movement toward online and phone quoting. These carriers will need a strategy and action plan to expand those efforts rapidly, in a cost-effective manner. Alternatively, some of these carriers will continue to ignore traffic migrating to the Direct space and will deploy the strategy of dominating a shrinking market channel. This will work for some carriers, but not for most.

All carriers pursuing the increased traffic online, over the phone, or with technologically savvy agencies, face the task of optimizing the marketing and distribution process from lead generation through purchase and retention. Understanding the lifetime value of these policies is crucial to understanding the acceptable marketing allowable for each segment and from each source of business. This will require new data collection and reporting, which ideally will extend to data collection and reporting with agency partners. With the reduced conversion that will accompany increased quoting, effective optimization will be even more crucial to keep acquisition costs per sale in line. Carriers without a strong optimization regimen (including the necessary data collection and reporting) face a significant risk of their efforts yielding unprofitable business (see Part 4).

As you contemplate how to address the COVID-related shift in consumer behaviors toward online and phone distribution, OutPerform can assist you in formulating and executing a unique approach that fits your business.

Up Next, Part 4: Pricing and Underwriting – In this document we will explore the challenges COVID will create in pricing and underwriting, and the interrelationship with distribution efforts.

About OutPerform Associates:

We provide guidance and assistance to P&C insurance carriers in building, implementing, and optimizing winning distribution and operational strategies.

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Citations

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