Abstract
This chapter details the use of different insurance distribution systems in practice, analyzes key issues in distribution system use based on economic theories of the organization of the firm, and discusses public policy and regulatory issues related to insurance distribution. The chapter focuses on what we believe to be the three major economic issues in insurance distribution: the choice of distribution system(s) by an insurer; the nature of insurer-agent relationships, including compensation structure and resale price maintenance; and regulatory oversight of insurance distribution activities, including regulation of entry and of information disclosure to consumers.

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22.1 INTRODUCTION

Firms in the insurance industry vary along many dimensions, including product distribution systems. A wide variety of distribution methods are used in the industry. Insurance distribution systems span the spectrum from the use of a professional employee sales force, to contracting with independent sales representatives, to direct response methods such as mail and telephone solicitation. The ongoing competitive and technological revolution in the financial services industries has resulted in greater segmentation of distribution by product market, and greater use of multiple distribution methods by firms, including the establishment of marketing relationships and alliances with non-insurance concerns.

The purpose of this chapter is to detail the use of insurance distribution systems in practice, to understand their use from a theoretical perspective and to discuss public policy and regulatory issues related to insurance distribution. Two points about the
chapter are worth noting in advance. First, because much of the academic literature on insurance distribution has focused on the United States, and because we have greater access to databases on that country, most of the detailed discussion of insurance institutions in this chapter will refer to the U.S. marketplace. We make reference to insurance distribution in other countries where the data are available, but refer the reader to other sources for details on these markets. The second noteworthy point is that the academic literature on insurance distribution is quite narrowly focused. There are many interesting and important issues that have received little or no attention in the literature. The approach taken in this chapter is therefore to discuss not only the state of knowledge from existing literature, but also to raise questions arising from economic theory regarding areas that need further research.

We focus our discussion on what we believe to be the three major economic issues in insurance distribution. The first is distribution system choice. Due to the variety of distribution systems employed in the industry, the differences in contractual relationships across them, and the recent market share gains of nontraditional distribution systems, an important area of research is the optimal choice of distribution system. Much of the existing research on property-liability insurance distribution has examined aspects of this question. This will continue to be an important question for both property-liability and life insurers, as the use of multiple distribution systems becomes increasingly common.

Closely linked to this question are others regarding the nature of the insurer-agent relationship. One particular area of interest is the structure of agent compensation. The differences in agent compensation structure across different distribution systems have received attention in property-liability insurance. Questions also surround the incentive effects of commission compensation schemes with regard to agent service and information provision, and, in the life insurance industry, unethical practices such as unnecessary policy replacement (often known as twisting). Compensation structure is also related to agent incentives to offer price discounts via commission rebating, a practice outlawed in all U.S. states until recently.

The final issue that we explore is regulatory oversight of insurance distribution activities. Life insurance sellers in many countries recently have come under criticism for misleading sales practices or high-pressure tactics. Agents have been alleged to exaggerate the benefits of their policies or fail to reveal key elements of risk to policyholders. In response to these and similar concerns, information disclosure regulation for both life and property-liability insurance sellers has been strengthened significantly in several countries, and is being considered in others. As new regulatory systems are designed, questions intensify regarding the need for such regulation, the appropriate regulatory mechanism, and the effectiveness and results of regulations.