# *When Big Really is Better than Huge*
# *By Chris Burand*

Companies today are pushing, requesting, cajoling, and demanding bigger and bigger books of business from their agents. Several companies have recently dramatically increased their minimum qualifying volumes for contingency bonuses as a means toward achieving their goal. Others are simply pulling contracts for low volumes and raising minimum requirements to maintain all contracts, not just contingency contracts. Big, national stock companies are leading this race but nearly all companies are headed in this direction. Does this strategy make sense?

***Avoid the Small***

In many ways, this strategy is smart and long overdue. Profit margins on small books are minimal or, more likely, negative. For example, the following actual results are typical for a large, national stock company:

$3.7 billion direct written premium
17% non-commission expense ratio
14.5% commission ratio
5% growth
70% average loss ratio
15% LAE
5,000 independent agents
$740,000 average direct written premium per agency

This company, like most, is not growing fast so a large part of its non-commission expenses are related to renewals and maintaining their agency force (i.e., distribution of manuals, rates, underwriting guidelines, and so forth; visits to the agency; licensing; and a normal distribution of overhead by agency). These expenses are fixed because up to a point, they do not vary by book size. If 25% of these non-commission expenses are attributable to maintaining the agency, then fixed annual expenses per agency equals $31,450.

Using the company's average results, on a small book of $250,000 written and earned premium, the company will incur the following expenses:

70% loss ratio or $175,000
14% commission rate (commissions for smaller agencies are lower due to lower contingencies) or $35,000
15% LAE or $37,500
12.75% (75% of 17%) non-commission variable expense or $31,875

Excluding the 25% of non-commission expense which is fixed per agency, total expenses equal $279,375 for a combined ratio of 111.8%. Including fixed expenses per agency, total expenses equal $310,825 for a combined ratio of 124%! As a percentage of written premium, fixed expense equals 12.58 percentage points of expense!

Compare these results to the company's average book of $740,000 direct written premium per agency:

> 70% loss ratio or $525,000
> 14.5% commission or $108,750
> 15% LAE or $112,500
> 12.75% (75% of 17%) non-commission variable expense or $95,625

Excluding the 25% of non-commission expense which is fixed per agency, the total equals $841,875 for a combined ratio of 112.25%. Add the fixed expenses per agency, and the total equals $873,325 for a combined ratio of 118% compared with a small book's combined ratio of 124%.

As a percentage of the company's average written premium, fixed expense equals 4.25 percentage points of expense. On a $2 million book, fixed expense is a measly 1.57 percentage points of expense. Therefore, while most expenses are variable, the small amount of fixed expense incurred makes doing business with agencies with small books, all else being equal, very unprofitable.

Several years ago, I completed a study for a national carrier and found the average loss ratio on small books was much higher than the company's overall loss ratio. This company was a fairly typical company, therefore I doubt its results were an industry anomaly. Higher loss ratios on small books further exaggerate the monetary losses companies suffer on small books.

***Don't Go Too Far the Other Way***
While avoiding small books and pushing agencies to grow bigger books makes sense, too many companies, especially large national stock companies, are prone to pushing the pendulum too far the other way. Companies should not push for huge books too hard for two reasons. First, in an industry that grew by 1.8% in 1998 and 1.9% in 1999, companies are so desperate for growth, they are far too willing to pay agencies extra just to get and keep large books. Their combined ratio in these situations can easily exceed a company's overall combined ratio.

Second, by pushing agencies to grow much larger, companies are in danger of eliminating too many agencies. It's a classic case of being careful of what you wish for because you might get it. The trend is already evident. Larry Marsh of Marsh-Berry estimates only 15,000 independent agencies will exist in less than five years. I estimate venture capitalists and the like have set aside at least $5 billion to buy all types of agencies within the next 24-36 months. Marsh-Berry estimates the total funds available for consolidating agencies is $20 billion. $5 billion, and most certainly $20 billion, can eliminate most agencies.

For the last century, companies have wielded overwhelming control over both prices and expenses. With fewer but larger agencies and the industry's significant surplus, agencies will gain more pricing and expense power. Large agencies will demand more commissions and better pricing (and they are successfully doing so already). Large agencies get their demands because so many companies are reluctant to lose large books and they are going to do whatever they can, even if profits suffer, to make their big agencies/brokers happy. We are already seeing companies make seemingly ludicrous deals with large agencies/brokers. Many companies do not willingly agree to these agencies' demands (and would normally pull a contract immediately if a smaller agency made some of the more extreme demands we have seen), but they are so desperate to maintain their market share they agree to these agencies'/brokers' demands.

Some companies have recognized the shift in the power structure and the potential for an even greater change. The real wake-up call was the Marsh-McLennon acquisition of J & H. Marsh-McLennon and AON now write 67% of all large national accounts' direct written premiums. To counter this swing in power, a few companies have invested heavily in insurance agencies and brokers. Willis, the Hub Group, Talbot, and USI are prime examples. They each have significant backing by insurance companies. Many analysts have attributed insurance companies' investments in agencies as a survival strategy to maintain the agency system because without agencies, these companies would fail. Whether or not these acquisitions can outperform an investment in much safer bonds, especially when 60% to 80% of all acquisitions lose money for the buyer, makes this survival strategy dubious at best. Other companies are developing proprietary distribution methods, i.e. their own sales force, to counteract the power of big agencies. I believe the potential for success in this manner is also doubtful because as Adam Smith taught 225 years ago, and he has yet to be refuted, the most profitable endeavor is to spend your time, energy, and resources doing only what you do best.

***Find a Happy Medium***

The alternative to heavy investment in agencies or creating your own sales force—and the safest, simplest, and cheapest way to improve profits—is to find a happy middle ground between large and small books and to pay good agencies more money. Companies must find their optimal book size and to do this they must calculate their breakeven points by agency results. As complex as most company financial systems are, few companies know their breakeven points for policies, accounts, policy by line of business, or book size. The breakeven point, or the cost of a sale, is not simply the company's expense ratio plus loss ratio. An activity based expense allocation method is much more accurate. I believe the results of such information would show that large books with very large agents and brokers are quite unprofitable, just like very small books. Companies are simply giving too much away in their desperate attempt to gain market share.

Knowing their breakeven points, companies can determine what and how much they can offer for any size and type of book. Companies can also focus on maximizing their profits by working with agencies and books of the optimum size rather than blindly pushing for bigger, bigger, and bigger. Likewise, agencies with books below the breakeven point that are not growing and with no signs of growth, should definitely be eliminated.

***Better Contingencies, More Profits***

Companies can also improve their profitability by developing contingency contracts that pay very well for profitable books and by no longer subsidizing unprofitable books with profitable ones. Unfortunately, many companies are trying to reduce their contingency payments as a method for improving company profits. This is not a wise thing to do because a good contingency contract is one of the best, and definitely the cheapest, methods for improving an insurance company's profits.

Many companies are looking to cut their profit sharing because they treat contingencies as expenses. For example, many contingency contracts contain provisions enabling the company to limit their agencies' bonuses if the company's profits in any given year are too high. Think about this for a moment. If the agencies collectively generate low loss ratios and high profits for the company by doing a good job underwriting risks up-front, the company *cuts* all their agencies' contingencies! What a great incentive!

When a contingency contract is well-designed, bonuses are not expenses. They are incentive plans for the agency to give the company good business. They are incentives that increase the company's profits and as a reward for increasing the company's profits, the company shares a portion of those profits with the agency. They are like the stock options insurance company CEO's get. When the CEO does a good job, he or she gets paid well. Otherwise, they don't.

Contingency bonuses are also cheap compared to creating a direct sales force and if companies pay profitable agencies well, more smaller agencies can afford to stay in business. This will counteract the growth of large agencies while companies take no additional risks and without increasing their expense ratio!

Based on the contracts that have recently been changed and the many still being contemplated, it is evident some companies do not understand or believe a correlation exists between their achieving low loss ratios and having a good contingency contract. Having analyzed hundreds of contingency contracts on an apples-for-apples basis, I believe the correlation is extremely strong. Usually, the companies with the best contingency contracts have the lowest combined ratios.

Additionally, companies who view contingencies as expenses do not seem to expect that when they modify their contract, agencies will modify the kind and amount of business they send the company. While it is true some agencies do not even look at their contracts, more and more agencies are thoroughly reading their contingency contracts and analyzing them to determine which is the best. As a result, agencies do move business based on the quality of a company's contingency contract. If a company decreases their contingency bonus or makes it more difficult to earn, smart agencies will shift some portion of their business to other companies. The company's growth rate is likely to suffer as will its loss ratio because profitable business will be placed with companies that pay the best. The company may save some in contingency payments, but they will lose as much or more in lost growth and higher loss ratios.

Agencies can also move business easier now than ever before. Most companies are paying big bonuses for book rolls. Even more important, with the growth of captives, agencies are increasingly looking to move their most profitable business to captives and will continue to do so unless companies begin sharing more profits for low loss ratio business. The days of subsidizing high loss ratio agencies and risks with low loss ratio agencies and business are over. If companies continue to do so, they will lose their best risks!

Companies can make much more money by giving agents high paying contingency contracts than they can ever save by decreasing their contingency bonuses. All it takes is a few basic steps.

First, identify the company's most pertinent three goals and list them in order of importance. Examples of goals include profits, growth, volume, retention, consistently low loss ratios, automation, and mix of business.

Second, write a contingency contract that pays very well for achieving the desired goals. Remember, if the agents hit their goals and the contract is well written, not only will the agencies make more money but so will the company. Do not get greedy. Too many companies are afraid of not getting their share. Companies that pay well continually get their share of the profits and more!

Third, solicit your agents' opinions of the contract and get an outside analysis to learn if the contract is good *from your agencies' perspective*. When companies change their contingency contracts without considering their agencies, the results can be disastrous. We have seen companies lose millions due to the unintended effects of a single clause. We have seen contingency contracts created with the best of intentions but without any agency participation. The result is a contract that acts as a disincentive.

Fourth, introduce the new contract along with a lot of explanation. When introducing a new contract, a company has an excellent opportunity to strengthen agency relationships. While surveys show that most agencies feel they have good relationships with their companies, few agencies trust their companies to compensate them fairly. In particular, they do not trust insurance company contingency calculations. Too often the numbers used are not explained, huge IBNR's are added, large loss reserves are added the last week of December (as one company rep once said, "When the leaves fall, reserves rise!"), or some other factor is mysteriously increased. Dispel this belief by showing how the new contract truly is a profit sharing opportunity for those agencies that help the company reach its goals. Explain your contingency contract carefully to gain each agency's trust. I believe the results will be similar to those achieved by firms that practice open-book management, which, based on research by the National Center for Employee Ownership, results in 1.66% faster growth. The reason open-book management works is that employees trust management more and when they trust management more, they are more productive. When an agency trusts a company, they work harder to give the company good business.

Because agencies and companies are partners, they have many opportunities to benefit each other by viewing contingency contracts as incentive plans. By offering a well-designed contingency contract, companies and agencies can both watch their profits improve. Additionally, paying good agencies well will keep them from moving business to captives, help them stay in business, and strengthen them financially without harming the company.

Every day, many companies are digging themselves into a deeper and deeper pit. While companies in all industries today are feeling the need to get big to survive, bigness without profits is a losing strategy. The insurance industry is not like Internet IPO's where profits do not seem to matter. If companies continue to focus on BIG, their profits will continue to suffer and they will be left in a poor bargaining position with their remaining agencies.

***Chris Burand*** is president of Burand & Associates, LLC, an insurance agency consulting firm. Readers may contact Chris at (719) 485-3868 or by e-mail at **chris@burand-associates.com**.

NOTE: None of the materials in this article should be construed as offering legal advice, and the specific advice of legal counsel is recommended before acting on any matter discussed in this article. Regulated individuals/entities should also ensure that they comply with all applicable laws, rules, and regulations.

May 2000